TRANSPARENCY IN SMALL BUSINESS LENDING

HEARING

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TRANSPARENCY IN SMALL BUSINESS LENDING

WEDNESDAY, SEPTEMBER 9, 2020

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 1:00 p.m., via Webex, Hon. Nydia M. Velázquez [chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Finkenauer, Kim, Davids, Mfume, Chu, Evans, Schneider, Delgado, Houlahan, Craig, Chabot, Radewagen, Balderson, Hern, Stauber, Burchett, Spano, and Bishop.

Chairwoman VELÁZQUEZ. Good afternoon.

I call this hearing to order.

Without objection, the Chair is authorized to declare a recess at any time.

I want to thank you for joining us this afternoon for this official remote hearing. I want to make sure to note some important requirements. Let me begin by saying that standing House and Committee rules and practice will continue to apply during remote proceedings. All members are reminded that they are expected to adhere to these standing rules, including decorum.

With that said, during the covered period as designated by the Speaker, the Committee will operate in accordance with House Resolution 965, and the subsequent guidance from the Rules Committee in a manner that respects the rights of all members to participate. House regulations require members to be visible through a video connection throughout the proceeding, so please keep your cameras on.

Also, if you have to participate in another proceeding, please exit this one and log back in later. In the event a member encounters technical issues that prevent them from being recognized for their questioning, I will move to the next available member of the same party, and will recognize that member at the next appropriate time slot, provided they have returned to the proceeding.

If a witness loses connectivity during testimony or questioning, I will preserve their time as staff address the technical issue. I may need to recess the proceedings to provide time for the witness to reconnect. Finally, remember to remain muted until you are recognized to minimize background noise.

With that, let's jump in.

Affordable capital fuels new start-ups and helps existing businesses expand into new markets and grow their customer base.

And we know that when capital is accessible on fair terms, small businesses can do what they do best, strengthen our communities and fuel our economy. However, predatory lending practices and lack of oversight can put many small businesses out of business. Last summer, our Committee examined the use of confessions of judgement by predatory online lenders. That hearing highlighted how merchant cash advance companies and online lenders have been able to skirt state and federal laws, and include predatory loan terms on small business owners.

That hearing crystallized my belief that there needs to be more transparency, accountability, and oversight, in the small business lending arena. We all know that the internet and technology has changed our lives for the better, allowing consumers and businesses to buy virtually any product online, access healthcare, and even educate our children.

That also is true for how we manage our finances. I am sure that everyone participating today has recently gone online to pay a bill, get a home mortgage quote, or sent money to a friend or family member. Small businesses, many of whom the large traditional money center banks do not serve, has turned to the internet for capital to start a business or operate an existing one.

Today's discussion is also extremely timely as economic uncertainty due to COVID-19 remains high. Access to credit for small firms may be even more challenging than usual. In this unique environment, online, or FinTech lending, has continued to grow, and remains an attractive option for small businesses seeking capital. For small business borrowers, the biggest advantage of FinTech is the ability to access capital after being denied a loan by a traditional lender.

In many cases, FinTech lenders are able to meet the needed payroll, inventory, or overhead needs of a small business, and, in some cases, disburse funds in as little as 48 hours. FinTech lenders are also likelier to make small-dollar loans generally considered too small to be profitable by most banks, but which, predominantly, go to women and minority-owned small businesses. With minority owners being almost twice as likely to apply for a loan online versus a traditional lender, it is critical for them to be able to seek capital online, and be assured the terms are fair, transparent, and affordable.

However, as this Committee has explored, there are also potential risks for small firms seeking capital online. Aside from confessions of judgment abuses, observers have noted a considerable lack of transparency in the underwriting process for many FinTech small business loans. It remains unclear whether lenders, or other actors, in the space are using certain information about applicants to discriminate.

Furthermore, not all FinTech lenders disclose the cost of capital in a way that is clearly presented and easy to understand for all small business borrowers. An economy where small businesses are sometimes paying 200 or 300 percent interest rates to keep their business running is not an economy that is working for all. It is a result of a patchwork of state laws, a lack of a federal regulator, and no federal law preventing exorbitant interest rates. It has become clear to us, and this Committee, through examples we have seen in prior hearings and in our interactions with business owners in our own districts, that small business owners applying for loans online are just as vulnerable as anyone to deceptive practices and unfair terms and have a right to a full and fair disclosure of all terms just like consumers.

Just because they do not have an army of financial and legal professionals, like big businesses, does not mean they should be left to fend for themselves when seeking credit. We all know that in order to maximize competition in a marketplace, all actors need to have as much and as accurate information as possible.

The same applies in the market for small business loans if you are the borrower, you need as much and as accurate information about your loan options as possible in order to make the best decision for your business. That is why, earlier this summer, I introduced the Small Business Lending Disclosure and Broker Regulation Act, which will expand the Truth in Lending Act protections and disclosures, or TILA, that currently apply for consumers who also apply for small business loans.

My bill will bring needed transparency to small business credit markets, ensuring entrepreneurs understand their obligations and rights when they sign up for a loan. I should point out that these efforts are already underway at the state level, with California enacting a similar bill into law 2 years ago, and another version recently passed the New York State legislature, and is awaiting approval by Governor Cuomo.

It is long overdue that we take this fight for fairness on behalf of small businesses to the federal level. In this pandemic, entrepreneurs have faced, and will continue facing, some of the most difficult and uncertain economic conditions ever, and it is vital we ensure predatory lenders do not exploit this situation by enticing small businesses into unfair and unsustainable loans.

Fortunately, some lenders already conduct the business of online lending in a responsible way, and are able to do it sustainably while making a positive impact on their communities. We will hear from one of those lenders soon. We will also hear from legal experts and advocates who will illustrate the impact of applying TILA to small business loans on minority communities, since small businesses usually represent one of the few wealth-building opportunities for people of color, and, in many cases, can serve as an official community center for the neighborhood.

I look forward to today's discussion. Again, I want to thank the witnesses for joining us today, and now yield to the Ranking Member, Mr. Chabot, for his opening statement, and I will ask members to please mute their mics. Thank you.

Mr. Chabot, you are now recognized.

Mr. CHABOT. Thank you, Madam Chairwoman, for holding this important hearing on the impact of FinTech and online lending on the Nation's small businesses. As the current Ranking Member and former Chair of this Committee, I have had the pleasure to speak directly with small business owners for many years, both in my district and across the country. Whether it is talking to small business owners or their employees, their input is critical in determining best way to support our small businesses, which are the backbone, after all, of this Nation's economy.

To say that America's small businesses have some of the hardest working people in the entire country would be an understatement. They rise early. They stay late to meet the challenges of their customers daily. They are also responsible for creating two out of every three new private-sector jobs in the country. To meet the needs and expectations of their customers and to grow and thrive, these small businesses require, as you mentioned, access to capital.

Unfortunately, Main Street businesses continue to report that capital access is one of their greatest challenges. Moreover, the current COVID-19 crisis has exacerbated this problem for our Nation's job creators. And, of course, access to capital continues to be one of the top issues that this Committee tackles, and, fortunately, under your leadership and previously under mine, in a bipartisan manner, because we are, I think, the most bipartisan Committee in Congress, and that is why we get the most done.

That is why today's hearing on FinTech and online lending is so important. As small businesses faced local and State shutdowns due to COVID-19, this Congress and President Trump unveiled the PPP, Paycheck Protection Program, to assist small businesses and their workers, for my State, Ohio, to your State, New York, to Florida, to Texas, to California, and all across the entire country. By utilizing private sector lenders, PPP was able to deliver financing quickly, and, for the most part, effectively. While there were only a limited number of FinTech companies participating in the program, [inaudible] delivered literally billions of dollars for America's small businesses.

Given the FinTech's growing popularity, it is critically important for this Committee to examine their role moving forward. These companies are driving innovation within our financial ecosystem. They are utilizing data to make rapid lending decisions. Conversations on disclosure requirements are necessary to ensure transparency is appropriate, and to protect America's small businesses as well. So that is obviously something that we need to consider as we consider this important issue. I am looking forward to discussing all of these topics today, including how these types of lenders should operate within the confines of the SBA existing programs.

Additionally, I am hopeful our conversations today help determine how FinTech and online lending is regulated, if that is going to occur, at the Federal level. We know that all the witnesses have busy schedules, so we appreciate them joining with us here today virtually.

And with that, Chairwoman Velázquez, thank you for holding this hearing.

And I yield back.

Chairwoman VELÁZQUEZ. Thank you, Mr. Chabot.

I would like to take a moment to explain how this hearing will proceed. Each witness will have 5 minutes to provide a statement, and each Committee member will have 5 minutes for questions. Please ensure that your microphone is on when you begin speaking, and that you return to mute when finished.

With that, I would like to thank our witnesses for taking time out of their busy schedules to join us. Our first witness is Ms. Luz Urrutia, CEO of Opportunity Fund, a CDFI and SBA lender based in San Jose, California. Opportunity Fund is one of the largest nonprofit lenders in the country and recently established a partnership with two large FinTech companies. Welcome, Ms. Urrutia.

Our second witness is Ms. Yanki Tshering, Executive Director of the Business Center for New Americans, a CDFI and SBA micro lender serving New York City. Beyond helping underserved entrepreneurs access affordable capital, Ms. Tshering was also recently a key advocate in the efforts before the New York State legislature to advance true lending protections for businesses across the state. I particularly thank you, Ms. Tshering, for your advocacy on behalf of all New York entrepreneurs, and welcome you before us today.

Our third witness is Professor Adam Levitin. Professor Levitin is the professor of law at the Georgetown University Law Center, with a focus on banking and finance law, bankruptcy law, and consumer protection. As an expert in this field, he has testified before Congress on numerous occasions, including last Congress before the Financial Services Committee on this issue.

Welcome back to the Small Business Committee, Professor Levitin, and I look forward to hearing your views on the interplay between FinTech and small business lending.

Finally, I would like to turn it over to the Ranking Member, Mr. Chabot, to introduce our last witness.

Mr. CHABOT. Thank you, Madam Chair.

Our final witness will be Michael Hiles. Mr. Hiles is the founder and Chief Executive Officer of 10XTS here in Cincinnati, Ohio. 10XTS is a software start-up company that is focused on blockchain technology and FinTech. Mr. Hiles has a long history of working within Cincinnati's technology sector. Prior to founding 10XTS, Mr. Hiles worked in the software development at Sabre Systems. He founded a web development company called Soft Links Interactive and worked at Proware.

Mr. Hiles was also responsible for setting up the Cincinnati chapter of Founder Institute, which assists business through the incubator and accelerator models. Mr. Hiles, I want to thank you for taking time out of your busy schedule to be with us today. It was my honor to speak with you recently on another call, and we look forward to your testimony here this afternoon.

And I yield back.

Chairwoman VELÁZQUEZ. Thank you, Mr. Chabot.

Now I would like to begin by recognizing Ms. Urrutia for 5 minutes. Thank you, Ms. Urrutia.

STATEMENTS OF LUZ URRUTIA, CEO, OPPORTUNITY FUND, TESTIFYING ON BEHALF OF THE RESPONSIBLE BUSINESS LENDING COALITION; YANKI TSHERING, EXECUTIVE DIRECTOR, BUSINESS CENTER FOR NEW AMERICANS; ADAM LEVITIN, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER; AND MICHAEL HILES, FOUNDER AND CHIEF EXECUTIVE OFFICER, 10XTS

STATEMENT OF LUZ URRUTIA

Ms. URRUTIA. Good afternoon, Chairwoman Velázquez, Ranking Member Chabot, and Committee members. My name is Luz Urrutia, and I am the CEO of Accion Opportunity Fund and Opportunity Fund. Opportunity Fund is a CDFI and the Nation's leading nonprofit small business lender. We believe small amounts of money, and the right financial advice can have lasting changes in peoples' lives, drive economic mobility and build stronger communities.

Last year, we deployed $120 million in 3,200 loans mostly to minority immigrants and women-owned businesses. Accion Opportunity Fund is also a founding member of the Responsible Business Lending Coalition, a group of nonprofit and for-profits in the industry committed to transparency and innovation in small business lending.

Before COVID-19, small businesses were already facing significant challenges, accessing responsible capital. Main Street financial institutions do not generally lend directly to underserved small businesses for a variety of reasons—tight credit boxes, small dollar amounts, lack of profitability, risky industries. But since the Great Recession, many banks left communities, and FinTechs and online lenders stepped in to fill the gap. There is no argument that these lenders have transformed the marketplace by speeding access to capital, and some of them, not all, being transparent and responsible.

Unfortunately, it has also created many unprincipled lenders that are wreaking havoc across Main Street, charging exorbitant rates and providing products that lack proper disclosures and transparency. After COVID, we believe the lending landscape will be altered even further. Banks will tighten their credit boxes even more. Many FinTechs and merchant cash advances providers will retrench or fail due to their capital structures and portfolio losses. The result will be that underserved small businesses will have an even bigger challenge accessing capital.

To meet this capital need, Accion Opportunity Fund believes that innovative partnerships with responsible FinTechs will be crucial. An example is Opportunity Fund's partnership with Lending Club, a one-of-a-kind partnership between a nonprofit CDFI, and a responsible, for-profit, publicly traded FinTech lender. Lending Club has the marketing reach and partnerships to provide an accessible digital experience for small businesses in need.

Opportunity Fund combines its credit assessment tools and a high touch customer service model to provide small businesses with responsible credit and transparent rates. The partnerships provide capital and technical assistance to businesses whose needs may not be met, or might pay significantly more with other providers.

More than 50 years ago, Congress enacted the Federal Truth in Lending Act to protect Americans from scrupulous lenders, making deceptive offers of credit. Unfortunately, we do not have those same protections for the Nation's small businesses. Opportunity Fund analyzed the data set of alternative loans held by small business owners who came to us hoping to refinance. We found that unregulated lenders were charging an average APR, annual percentage rate, of 94 percent with an average monthly loan payment nearly double the borrowers' net incomes. One loan was priced at an astounding 350 percent. These loans put many small business owners in a crushing cycle of debt.

Take Deanna Irish, owner of Wine Tour Drivers, in Sacramento, California. Deanna took a $25,000 online loan that cost her $2,000 a month. She was able to refinance with Opportunity Fund cutting her payment to $900. Since then, she has been able to pay off her loan. These high rates are unfair and deceptive, often hidden under layers of misinformation. Federal research also finds that small businesses are often misled by disclosure quoting non-APR rates. The inability to compare prices on an apples-to-apples basis, and lack of transparency, stymies free market competition that could lower prices and spur financial services innovation.

I want to thank the Chairwoman for introducing the Small Business Lending Disclosure and Broker Regulation Act of 2020, which will deliver much needed protections to small businesses. Research also shows it will bring over $3.8 billion in savings to nearly 800,000 small business annually, including hundreds of millions in savings for over 158,000 minority-owned small businesses. The legislation could not come at a better time, when many business owners are desperately seeking for ways to remain solvent. An uninformed business decision for a financing choice could be the difference between survival and failure. We applaud California and New York for passing legislation mandating transparency in small business lending, however, a State-by-State approach hampers innovation and increases costs for lenders. This national approach is much needed to provide clear and concise national regulations that protect all small businesses equally and allow responsible lenders to innovate and create quality products.

I encourage all of our leaders in Congress to work together to pass the Small Business Lending Disclosure and Broker Regulation Act of 2020.

Thank you.

Chairwoman VELÁZQUEZ. Thank you, Ms. Urrutia.

Ms. Tshering, you are recognized for 5 minutes.

STATEMENT OF YANKI TSHERING

Ms. TSHERING. Thank you. Thank you, Chairwoman Velázquez, Ranking Member Chabot, and distinguished members of the Committee. Thank you for inviting me to speak with you today about the lack of transparency in small business lending, and the urgent need to provide entrepreneurs with the information they need to make informed decisions.

My name is Yanki Tshering, and I am the executive director of the Business Center for New Americans, a treasury-certified Community Development Financial Institution and Small Business Administration micro lender and community advantaged lender based in New York City.

In addition to my role leading BCNA, I have also served on the board of the New York State CDFI coalitions since 2015. BCNA was founded to help hard-working immigrants and refugees pursue the American dream. Over two decades, we have provided financial counseling and loans to help clients to start or grow a business, buy a home, or save for the future. BCNA serves exceptionally diverse clients. Our micro and small business clients range from the street vendor who comes in once a year to borrow $500 to fund his inventory of roses for Valentine's Day to the deli owner operating six grocery stores with 80 employees.

Since we were founded, BCNA has made over $33 million in micro and small business loans, and provided training and advice to over 10,000 businesses. One of those businesses is Haute Knit whose owner, Vladimir Teriokhin, produces knitted garments for New York design houses. Vlad was initially thrilled when he was approved for a $35,000 loan from an alternative FinTech lender that he found online, but gradually realized to his horror that he was paying over 61 percent in annualized interest.

When Vlad came to BCNA 3 years ago to ask us about a loan, part of which he would use to pay off that high interest loan, we were shocked to learn that he was also required to pay the full amount of interest and fees, even if he was able to prepay the loan, something he didn't understand when he signed off for the loan.

We are happy to have been able to help him with financing that loan and many more for affordable terms that are transparent and fair. Unfortunately, now, more than ever, small businesses are suffering from a lack of access through responsible transparent credit. The Truth in Lending Act, originally passed in 1968, requires lenders to clarify, disclose their pricing, and terms for consumer loans, but does not apply to financing for commercial loans.

This means that small business owners like Vladimir are left to face a Wild West of unregulated and increasingly complex financial products without any consistency in how the lenders explain, or present their products to borrowers.

We regularly assist clients who have encountered alternative loan products, such as merchant cash advances that they did not understand at times with dire consequences. Larger, more established businesses are able to hire attorneys and accountants to translate confusing term sheets, but as members of the Committee know very well, the overwhelming majority of small and micro businesses don't have the funds for that level of legal assistance.

This is why we are very happy to be here today in support of Chairwoman Velázquez's recently introduced Small Business Lending Disclosure and Broker Regulation Act, which will ensure that no small business is left behind and extend sensible disclosure protection to entrepreneurs nationwide.

Thank you.

Chairwoman VELÁZQUEZ. Thank you, Ms. Tshering.

Now we recognize Professor Levitin for 5 minutes.

STATEMENT OF ADAM LEVITIN

Mr. LEVITIN. Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee, good afternoon. Thank you for inviting me to testify before you today.

My name is Adam Levitin. I am a law professor at Georgetown University, where I teach courses in commercial law and financial regulation. For over 50 years, consumer credit has been governed by an extensive Federal regulatory regime of disclosure, substantive term regulation, and supervision of lenders. There is no equivalent regulatory regime for business loans. The lack of regulation of business lending is, in large part, because businesses are presumed to be more sophisticated entities than consumers, and, therefore, less needing of governmental protections. Yet, there is a considerable range of financial and legal sophistication among businesses and the reason that a borrower takes out a loan does not determine the borrower's ability to otherwise protect his or her interests.

Small businesses, in fact, often resemble consumers in terms of limited information, sophistication, and market power in credit markets. Moreover, small business borrowing is often personally guaranteed by the small business's owner. The lack of regulation leaves small business vulnerable to abusive practices of the sort that were prohibited in consumer credit markets in the 1960s and 1970s. It makes sense to recognize that small businesses need many of the same sorts of protections as consumer borrowers to ensure that they can enjoy fair, efficient credit markets. And that is precisely what the Chairwoman's bill, a Small Business Lending Disclosure and Broker Regulation Act would do.

Most importantly, the Chairwoman's bill would extend the centerpiece of Federal consumer credit regulation, the Truth in Lending Act, to small business loans. The Truth in Lending Act requires, among other things, the standardized disclosure of the cost of credit in the form of the finance charge and the annual percentage rate, or APR. That is an annualized measure of the finance charges as a percentage of the principal obligation.

Standardization of credit cost disclosure is important, because it enables borrowers to more readily understand and compare various credit offers available on an apples-to-apples basis, so that the borrowers can make an informed decision about using credit. Informed use of credit is essential for ensuring robust price competition, which is the first line of consumer protection.

Let me give you an example of what the world could look like without standardized credit cost disclosure. If I were to tell you that a loan cost 10 percent without telling you more, you could not tell if that meant 10 percent annually, 10 percent monthly, or 10 percent weekly; much less, if that 10 percent were compounded and with what frequency. That actually leads to very different effective interest rates. Without compounding, the 10 percent monthly figure would translate to 120 percent annually, and the weekly figure, to 520 percent annually.

So the imprecision of stating 10 percent interest allows for abuses of consumers. Let me illustrate this with a story of small business from Sarasota, Florida called Homes by DeRamo. And this is the story experience with a predatory small business lender, called World Business Lenders, that operates in partnerships with various banks that rent out their banking charters to enable the nonbank lender to evade State laws.

So the DeRamos got a loan from World Business Lenders through a small Wisconsin bank with two branches, called Bank of Lake Mills. It had no connection whatsoever with Florida. And the pricing of the DeRamos' loan was never disclosed as an annual percentage rate. Instead, it was disclosed in terms of a daily percentage rate, and that appeared as a 12-digit decimal figure of just over 0.33 percent. Annualized, however, that translates into 121 percent APR.

That 121 percent APR figure never appeared anywhere in the DeRamos' loan documents, however. Moreover, even the daily percentage rate, was never prominently disclosed. It was buried in the midst of legalese. No interest rate whatsoever appeared on the summary term sheets for the loan. Instead, the only percentage figure that appeared was for 15 percent prepayment penalty and that is the figure that the DeRamos believed was the interest rate on the loan.

So the Chairwoman's bill would address this sort of abuses that occurred with the DeRamos' loan, by requiring disclosure of credit cost in standardized terms. It would also prohibit the sort of gotcha-type of enormous prepayment penalties for same lender refinancing as the DeRamos experienced. And most importantly, I think, it would extend the scope of the Consumer Financial Protection Bureau's regulatory authority so that the CFPB can supervise the larger participants in the small business lending and use its power to prohibit unfair and deceptive acts of practices as a gap filler.

I would urge the Committee to take up the Chairwoman's bill, which is an excellent point for bringing much needed protection to small business borrowers.

Thank you.

Chairwoman VELÁZQUEZ. Thank you, Professor Levitin. Now we recognize the gentleman, Mr. Hiles, for 5 minutes.

STATEMENT OF MICHAEL HILES

Mr. HILES. Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee, thank you for the invitation to testify at this hearing.

My name is Michael Hiles, and I am the CEO of 10XTS, a Cincinnati-based FinTech/RegTech company building blockchain solutions for financial records. The SBA's admirable effort to rapidly mobilize financial stimulus through EIDL and PPP loans demonstrates how small business funding is clearly an essential lifeline to a thriving economy. When American small business is unable to access capital, single moms, immigrants, and regular ordinary people suffer. The SBA is historically partnered with banks as the origination and servicing agents for lending programs. While this approach has generally allowed the SBA to serve a wider market, the administration can only be as effective in delivering services and support as their partners. Therein lurks the problem faced by the SBA.

The PPP program experienced significant delays in delivering financial relief to small businesses due to many banks' inability to adjust business operations in an agile fashion and fairly deliver funds in a diverse and inclusive ways. We directly experience these frustrations.

Legacy banks are already in the throes of compressive disruption. They are not in a position to quickly respond to rapid, disruptive changes in the market. The resulting permanent branch closures and downsizing has been an alarm bell for many. In 2018, Gartner published a report indicating that by 2030, 80 percent of the traditional financial services firms will close, become commoditized, or exist formally, but will not compete effectively in the market.

With so many consolidations, banks have struggled to merge redundant, legacy IT systems. The largest banks are a hodgepodge of too-big-to-fail technology strung together with little to no standardization. As a result, institutions are weighed down with inefficient fragmented processes. Our hypothesis at 10XTS is that a bevy of problems are mostly based on how information, records, documents, and data are stored, managed, shared within, and between other organizations and customers. Trusted information is still mostly another human vouching for the authenticity of documents and data.

Facing increasing regulatory scrutiny, banks have been reluctant to drive innovation due to the inherent compliance risks. Financial services industry already spends more than $270 billion per year in compliance and regulatory obligations. Legacy systems limit the simple automation and straight-through processing from front end to the back office. Proprietary systems complicate the adoption and integration of emerging tech like blockchain, AI, robotic processing, and API-based micro services. In short, legacy information systems reduce a bank's ability to innovate and improve value for their customers and partners.

Meanwhile, there are now approximately 60 million Generation Z banking customers who control $45 billion in annual spending. With the oldest of them nearing age 24, these young adults literally have no recollection of life prior to the internet, social media, and mobile tech. Gen Z expects highly transactional services, placing more value upon convenience over traditional branch-based relationship-driven banking.

In consideration of these things and other things, I offer the following recommendations: One, coordinate efforts with the U.S. Treasury and Federal Reserve Bank in establishing a sandbox environment, and a decentralized national network of financial records. Without a definitive path of its own, relying on the financial services industry to provide tech solutions means the SBA is at risk for future disenfranchisement of the growing market of digital-first business' owners who rely upon tech solutions for fast, efficient business operation.

Similar to the early communications standards that became the internet and web, a collaborative approach to building a commercial lending and financial records network by the SBA, Treasury, tech companies, and banks could accelerate a more verdant, efficient, and trustworthy financial system. Through collaboration, the SBA is in a position to establish new standards for financial document and information networks, data interoperability, robotic process automation, and exchange.

Firms that optimize customer data, robotic processes, and provide new solutions can offer timely and relevant support for the SBA's programs. With data-driven and digital-only models, challenger firms are in a better position to adapt to rapid change and unforeseen circumstances.

Number two, leverage and improve upon small business innovation research, SBIR programs, to foster FinTech and RegTech innovation. The SBA has an opportunity to collaborate with technology companies to provide proof of concepts for the direct delivery of automated services. However, Federal contracting, grant, or regulatory policies can be quite prescriptive when it comes to defining technology and solution requirements.

Instead, Congress should establish goals for the outcomes of innovation programs and then strive to support businesses that offer effective, affordable technology solutions. While contracting vehicles already exist, they can be prohibitive for small companies to pursue due to the amount of resources required. As we have seen with recent SBIR innovations and instant procurements and streamlined processes within the Air Force, tapping into a wider national brain trust for innovation can be achieved through thoughtful improvements through the existing processes.

As we deliberate national small business, funding, banking, technology, and even monetary policies, Congress should invest in these opportunities, accelerate them where possible, and ensure the financial and regulatory standards and technology of the future continue to be led by American ingenuity and resolve.

Thank you, again, for inviting me to testify, and I look forward to addressing each of your individual questions.

Chairwoman VELÁZQUEZ. Thank you, Mr. Hiles. Thank you all for everything you have shared with us. I will begin by recognizing myself for 5 minutes.

Ms. Urrutia, the goal of my bill is to bring transparency and understanding of pricing terms and conditions to small business lending nationally. How would increased transparency have a unique impact on borrowers of color, immigrant entrepreneurs, and other vulnerable communities?

Ms. URRUTIA. First, I want to start by saying that underserved small businesses, particularly the minorities, immigrant, and women-owned do not generally maintain existing banking relationships. I think this was recently brought to light after looking at the results of who received PPP loans. Unfortunately, we saw that many minority immigrants and women-owned business who tried to apply with banks were left at the back of the line, or declined altogether. There is also plenty of research from many sources showing that these underserved communities are most negatively impacted when it comes to accessing responsible and affordable capital.

The Brookings Institute research shows that minority and women-headed households generally have lower levels of household wealth, making external borrowing more difficult. It also shows that these two segments have increasingly difficult times accessing responsible capital. Similarly, the U.S. Department of Commerce, Minority Business Development Agency shows that minority and women-owned businesses are less likely to receive loans, more likely to receive lower amounts, and more likely to be denied when compared to nonminority businesses.

Chairwoman VELÁZQUEZ. Thank you. Thank you. I just need to go on with other questions. Thank you so very much.

Ms. Tshering, you noted that nonprofit lenders are left helping small businesses pick up the pieces due to the lack of transparency and abusive lending practices in online lending. Can you elaborate on some of the terms these FinTech products have that hurt small business borrowers?

Ms. TSHERING. So what we found and it is the CDFI Business Center For New Americans, which I represent, but also all—we have a coalition of CDFIs in New York State, and we work very closely together. What we found is the, you know, lack of transparency of the actual interest rate. And I think we had someone who just spoke, the professor, who explained in detail, you know, very often the fact that the interest rate is a daily interest rate is not conveyed clearly to the borrower.

So when you actually—you don't have the ability to compare apples to apples. So a borrower may look at a CDFI's loan product offerings and see 8-1/4 percent, and 10 percent, and when they see the interest rate that is conveyed to them by a FinTech, or an online, or some other lender, they are very confused. So, you know, we greatly feel what we are asking for is transparency and fairness. We are not condemning the FinTech sector. We are condemning and bringing to light the bad behavior.

The other thing that we were shocked to find out, and I have to point this out, was the fact that even if we stepped in, a CDFI stepped in and was willing to make a loan to refinance, this loan with this exorbitant interest rates because of what the client on the borrower small business owner had signed on, it was still liable for the entire fees and interest for the term of the loan.

Chairwoman VELÁZQUEZ. Thank you, Ms. Tshering.

Ms. Urrutia, in an effort to increase transparency in small business lending, an unexpected degree of disagreement has a reason with respect to annual percentage rate, or APR, disclosures. Some have argued that a total cost of capital metric is appropriate, but others have argued that an APR cannot be calculated for certain products.

What is your response, and why is it so important that APR specifically be disclosed to borrowers? Do you believe it is more accurate or useful metric for borrowers in comparing loan products?

Ms. URRUTIA. They are providing capital over time for a fee just as lenders are. For a long time, the merchant cash advance industry has long claimed that their products are different to get around regulations that are intended to protect their customers. This is just another example of that avoidance. A lot of conversation focuses on the nuances of the product themselves. Are they an MCA? Are they a daily debit? What are the product features? This financing is mostly very high cost and doing more harm than good.

You know, customers need to be educated. The best businesses educate their customers because that allows them to make informed decisions. APR is definitely a metric that helps borrowers understand how much they are paying, and be able to compare apples to apples, one product to another.

Chairwoman VELÁZQUEZ. Thank you. Thank you. My time has now expired, and maybe if we go to a second round of questioning, I will be able to ask question for the witnesses that I haven't gotten to yet.

Now, the Ranking Member, Mr. Chabot, is recognized for 5 minutes.

Mr. CHABOT. Thank you, Madam Chairwoman, and I will begin with Mr. Hiles.

Mr. Hiles, Cincinnati is a modest-sized city. How is Cincinnati come to be such a significant driver of financial innovation? What advantages have you found here in this area?

Mr. HILES. Madam Chairwoman, Ranking Member, thank you for the question.

Cincinnati has a great legacy of financial technology. In 1976, that was the start of the electronic trading with the Cincinnati stock exchange. In fact, Cincinnati is recognized as being the first independent software vendor company in history, Cincom Systems. So it has a wonderful technology legacy that was followed through. In 1977, Fifth Third Bank launched the very first ATM network, the Genie Network, which has become fairly ubiquitous now throughout the world for accessing cash through trusted networks. Separately, I am honored to have been on the team that was the first to ever connect a court judicial case management system to the world wide web and allow a clerk of courts case management search look-up, and we won a Smithsonian Computer World Laureate award for that.

So we have got a tremendous history of firsts, and that is one of the reasons that we are now also advocating the establishment of a decentralized network of records as a way to really provide proof and efficacy of financial identities, entity information, assets, and, ultimately, transactions, so that they can be queried instantly by regulators, but then also ensure the security and the efficacy of documents and data as they are passed between institutions and organizations and individuals.

So that hopefully answers the question, Ranking Member. Thank you.

Mr. CHABOT. Thank you very much.

Ms. Urrutia, I will go to you next. Could you expound upon the partnership that Opportunity Fund has with LendingClub and Funding Circle and how that those partnerships have helped reach small businesses across the country?

Ms. URRUTIA. Sure. We established a one-of-a-kind partnership where we were able to take LendingClub customers that applied for a loan and got denied, primarily for credit reasons, in the background we were able to check them to decide if we could provide them a prequalification offer. In essence, we were a second look for a FinTech lender. They brought the marketing and, their digital capabilities, and we brought our high-touch customer service and our ability to underwrite credit for these underserved consumers, giving access to credit to borrowers that, otherwise, would have been turned down.

And for certain borrowers that we cannot handle because their loan sizes are greater and/or they are prime creditworthy customers, we would send them to another lender, such as Funding Circle for them to underwrite; again, better expanding access as well as providing transparent rates and affordable loans.

Mr. CHABOT. Thank you very much.

Ms. Tshering, I will go to you next. As we have seen, COVID-19 has acutely impacted small businesses across the Nation. This is especially true for the country's smallest firms. I have introduced legislation that considers the smallest of small businesses, those that have 10 or fewer employees.

As Congress looks to assist these smallest of hard-hit businesses during this emergency period, do you have any suggestions as to what we could consider why these smallest businesses have a particularly hard way to go?

Ms. TSHERING. That is a great question. Thank you.

So one thing I want to, you know, thank everyone who is involved in passing the CARES Act, one of the provisions that is not talked as much about as the PPP—we hear so much about the PPP loans, was under the CARES Act, anyone who was funded with the loan from funds from the SBA were able to get 6 months of loan repayments assistance under the CARES Act.

So, that was a lifeline for small businesses that had a loan funded by the SBA, many of the EIDL loans, others were really, really helpful, but when we speak to our clients and other clients of other CDFIs, the area where most of the businesses seem to really need help is some form of rent relief. And what they have also said over and over, again, is, Yes, we do not need more debt, you know. We would love to have a program which would, you know, provide some equity, help us pay off the 4 months of rent that we owe, and some of the expenses so we can get back on track.

Mr. CHABOT. Thank you very much. My time is expired, Madam Chair.

I yield back.

Chairwoman VELÁZQUEZ. Thank you. The gentleman's time has expired.

Now we recognize the gentlelady from Kansas, Ms. Davids, for 5 minutes.

Ms. DAVIDS. Thank you, Chairwoman Velázquez and Ranking Member Chabot, for holding this hearing today. The COVID-19 pandemic has certainly illustrated and exacerbated many of the challenges that our small businesses face in their ordinary day-to-day operations, whether we are talking about access to capital, starting a business, keeping the doors open in an emergency, and we are seeing just how hard those challenges can be.

FinTech, I think, presents a unique and exciting opportunity for lenders to better reach and serve small business owners who are often in search of small loans, things, you know, loans that are under $1 million, and FinTech lenders are often able to speed up the typical loan turnaround time, which can be critical for small businesses with tight margins.

But, as we know, the FinTech industry, as it grows and adapts, we have a responsibility to ensure that those opportunities for small business lending are equitable and that they are fair. And so, Ms. Urrutia, I would really love to hear from you about how we ensure that FinTech and online lenders offer fair and clearly understood terms, and making sure that they are remaining accessible to small lenders and you were kind of touching on this earlier when you were talking about the transparency that the Chairwoman was asking about, but also, just in terms of making sure that folks understand the terms that they are signing up for, how we educate folks on that.

Can you talk a little bit about that?

Ms. URRUTIA. Sure. Thank you.

First, there are many reputable national lenders. CDFIs and FinTechs alike, who deliver solutions online to customers throughout this country in both rural and urban communities. And these organizations, ourselves included, we meet borrowers where they are and when they need us. And we have been and will continue to be committed to transparency in our lending activities. Examples of many of these lenders are members of the Responsible Business Lending Coalition, which is a network of more than 110 non-profit and for-profit lenders, investors, and small business advocates that share a commitment to innovation in small business lending, and we also are concerned about the rights of small businesses. The 50-plus lenders in the group currently provide borrowers in need of loan capital with transparent disclosures.

The second point I will make is that we strongly believe that an educated customer is our best customer. By being transparent, we help them to understand how to pay loans back, which means more people can get credit as a result. For us and for these lenders, customer success drives business success.

Ms. DAVIDS. Oh, really quickly, I would like to hear a little bit more about—I am really interested in making sure that small business owners are able to trust that they are interacting with a lender that is really going to either meet them where they are at or educate them in a way that is necessary.

Can you talk a little bit more about that? The Responsible Lending Coalition sounds really interesting. Are there other groups out there that are doing similar work?

Ms. URRUTIA. Yes, and I would say that under the Responsible Business Lending Coalition, we created—the Business Borrower Bill of Rights, which outlines six principles of what responsible lending would look like. It does not mean that other lenders that have not signed on to this bill are not doing responsible lending, but I think that the BBoR will serve as a guideline for small businesses when taking out a loan to understandf if, the loan meets this criteria?

Ms. DAVIDS. And then, Ms. Tshering, I saw you nodding your head a bit. I would love to hear from you on this.

Ms. TSHERING. Yes.

So, you know, I want to point out, as Luz referred, that many who have not signed on to this, you know, small business lender Bill of Rights, but they believe in what we are asking for. And we are not, you know, condemning the FinTech sector, as I said before. What we are saying is, we want some rules in place to affect and make sure there is no bad behavior, which impacts very negatively on small business owners.

Ms. DAVIDS. Yeah. I appreciate that, and it sounds like there are a lot of—when I was hearing about the partnerships with folks like Lending Tree and other online folks, I think that it sounds as though, there is—again, I said this earlier, a lot of opportunities for access and growth just making sure we are making that a fair and equitable process.

Thank you so much for your responses.

And I yield back.

Chairwoman VELÁZQUEZ. The gentlelady yields back.

Now we recognize the gentlelady from American Samoa, Mrs. Radewagen, for 5 minutes.

Mrs. RADEWAGEN. Thank you, Chairwoman Velázquez and Ranking Member Chabot, for holding this hearing, and I, too, want to welcome the panelists.

For Ms. Urrutia, in your testimony, you state that small business owners are sometimes shut out of a traditional financial system. Why do you believe some lenders do not consider them good candidates for traditional lending products? And small businesses are—well, as Congress continues to discuss PPP and the next round of COVID relief, what should we concentrate on that would provide the most assistance to small businesses?

Ms. URRUTIA. Sure. Yes. Banks generally have a very specific criteria under which they make loans. They look at FICO scores, and there are a lot of small business owners and individuals that don't have one—primarily those that either new to credit or, immigrant communities. Second, they are looking at size of loans. The loans we are talking about are very small microloans. It is really hard to make those loans profitable. Also, many of these minority-owned businesses are in industries that pose a greater risk for banks, even though, we would disagree with that statement based on our own experience.

So, the overall profitability and the overall segment that we are talking about has needs that the banks are just not set up to serve. As a result, these small businesses are going to alternative lenders to seek the credit that they need; online, MCAs, FinTechs. In terms of PPP, we believe that there are several things to improve. We do believe that there needs to be the ability for businesses to access a second PPP loan. We also believe that to incentivize lenders to make smaller loans, lenders should get paid a minimum fee of $2,500. As an example, at Opportunity Fund, our average loan for PPP was $15,000, okay.

The average loan on the second round was 73,000 for the industry as a whole, and even larger in the first round. So, to incentivize lenders to make smaller PPP loans, there should be a process to forgive any loans under $150,000. That will help lenders be willing to make those smaller loans.

Mrs. RADEWAGEN. Thank you, Chairwoman Velázquez. I yield back the balance of my time.

Chairwoman VELÁZQUEZ. The gentlelady yields back. Now we recognize the gentleman from Maryland, Mr. Mfume, for 5 minutes.

Mr. MFUME. Well, Madam Chair, thank you very much. You are very gracious with your time. I hopped on a little late because I have had conflicting meetings this day, and so in deference to the members on our side that may have been here earlier before me, I would yield until the next round.

Chairwoman VELÁZQUEZ. I recognize the gentlelady from California, Ms. Chu, for 5 minutes.

Ms. CHU. Thank you, Madam Chair.

Well, Ms. Tshering, I am so glad you are on this panel today because your organization is a Community Advantage lender serving immigrant and minority business owners. What this hearing today shows is that it is so important for us to support the Chairwoman's Small Business Lending Disclosure Act ASAP.

And I have also introduced legislation, along with my colleague, Representative Spano, that would authorize the Community Advantage program for 5 years, which has been operating as a pilot program successfully since 2011.

Now, we are facing a long recovery from COVID-19, and we need to be bold about giving small businesses, especially underserved small businesses, more opportunities to access SBA capital.

So, you know, we have an interest in making sure the Community Advantage program remains live. And as a Community Advantage lender, can you speak to the potential of this program to play a part in the economic recovery for small businesses, especially those owned by immigrants and people of color, and especially when they may be potentially taken advantage of by unscrupulous FinTech lenders?

Ms. TSHERING. So, thank you. So, the Community Advantage product is a great product. We are relatively new to the product. We have been making these loans for 2 years. But what I have to say, we were pleasantly surprised once we started processing them, how efficiently we got a response as to whether something was approved or not, if a loan was approved, or if documents were missing. And I think it has a great role to play in the recovery efforts.

New York, here, businesses are reopening. We are making, you know, emergency microloans funded by the SBA. We are also a very active lender with funds, awards from the Treasury, the CDFI fund at the U.S. Department of Treasury. But the CA, Community Advantage program, has a great role to play.

And I think, you know, if more of the business owners were aware of the product, certainly there is some time involved in underwriting the loan, but that makes sense because, you know, you really have a responsibility to make sure that the borrower has the ability and, you know, is able to repay before you make the loan to the business.

Ms. CHU. Thank you for that.

And, Ms. Urrutia, as the only member from California on this committee, I would like to ask you about SB-1235, which was signed into law in my home State in 2018, and was the country's first truth-in-lending law specifically for small business. And I know your organization was very instrumental in the passage of this bill in my State.

Of course, this legislation did address the misleading advertising practices by requiring lenders to disclose the true estimated cost of their products on an annualized basis, and it laid the groundwork for a similar effort in New York State. And, of course, I commend Chairwoman Velázquez for spearheading these disclosure requirements here in Congress because we certainly need it on a national basis.

So, can you tell us how the bill is doing and expound on the lessons learned from SB-1235 in California, and how we can apply those lessons to the Federal level?

Ms. URRUTIA. SB-1235 has not been fully implemented yet in California, but, transparency is what we all were looking for. That is why when this bill was passed, there was no opposition to enacting some of the disclosures.

○–What we saw is that high-cost lenders continue to oppose it because their APRs will be much higher than the rates that they disclose now. As I said earlier, the Federal Reserve found instances of providers claiming that a 4 percent "fee rate" of 4 percent, when the estimated APR was 45 percent, or a "factor rate" of 1.15 when the estimated APR was 70 percent. The Fed found these rates are confusing.

So, when we introduced this bill, I think that the reason we found support is because consumers and small businesses deserve the right to know their options and what they are buying so they can make informed decisions. And we are looking forward to successful and full implementation of the bill in California.

Ms. CHU. Thank you. I yield back.

Chairwoman VELÁZQUEZ. The gentlelady yields back.

I now will recognize the gentleman from Ohio, Mr. Balderson, for 5 minutes.

Mr. BALDERSON. Thank you, Chairwoman. Chairwoman, I appreciate you doing this committee today, and I look forward to listening. It has been good today.

My first question will go to Mr. Levitin. In your testimony, you briefly discuss personal guarantees. At the SBA, personal guarantee is utilized with many of the government guaranteed lending products. Can you provide more detail about its role in traditional lending products?

Mr. LEVITIN. Sure. Personal guarantees are—commonly are very frequently used as business lending because the small businesses—in many situations, the dividing line between what is a small business asset and what is a personal asset gets—it can be fussy. That is one reason.

For example, a contractor who buys a Ford F-150 or something might use it for work, but he is also going to use it to take his kids to school, and to get groceries and the like. It is both—it may be registered in the business's name, but the business is really hard to separate from the person, and that is why you often see personal guarantees for all businesses where the credit of the business is just tied up with the credit of the person.

I don't think a personal guarantee is, in any way, a problem. I want to be clear about that. But when you start having personal guarantees it can make it look a lot more like [inaudible] than if, you know, a large—Coca-Cola were to go and take out a multimillion dollar loan.

Mr. BALDERSON. Thank you. I will follow up for you. What small business provision should Congress concentrate on while discussing the next COVID relief package?

Mr. LEVITIN. I think the key—maybe the most important problem small businesses are facing is rent, and that is not an easy problem, because you have small businesses that, through no fault of their own, are facing real problems with their rent, and you have landlords who, through no fault of their own, are finding their own liquidity stressed because of the COVID problems. I don't, unfortunately, have a good solution for you on this, but that is, I think, where a lot of attention needs to be paid.

Mr. BALDERSON. Okay. Well, thank you.

My next question is for Mr. Hiles. Mr. Hiles, thank you for being here today. What do you believe are the factors that are driving change within the country's banking and lending system?

Mr. HILES. Madam Chairwoman, Representative Balderson, thank you for the question.

There is a confluence of different factors affecting the banking system right now. As I stated in my initial testimony, one of the problems through consolidation for Main Street to Wall Street has been the development of these gigantic too-big-to-fail patchwork quilts of disparate financial IT systems in the way that the documents and the data are managed become very expensive to maintain.

And we have seen instances where very large banks have spent upwards to $1 billion in an attempt to launch a fully automated digital bank from the inside out. And we know that from the technology standpoint, the technology innovation generally takes place outside of large institutions and then becomes acquired or absorbed within as we are able to innovate and pivot.

There are other compressive factors, you know, the risks from a regulatory cost standpoint and, you know, not clear guidance. We have struggled with standards in technology. We have had a little bit of a national dialogue, in particular, around blockchain. There has been an attempt to bring to the floor a previous legislation that defines even the taxonomy of blockchain and cryptocurrency and trying to inject some definitions into the mix.

I would like to also remind the committee that FinTech, in and of itself, is not necessary alternative lending. FinTech is just financial technology that powers an efficient way for even traditional financial firms to continue to operate.

Mr. BALDERSON. Thank you very much for your answer.

Madam Chair, I will yield back my remaining time. It is pretty short. So thank you very much for all of you being here today.

Chairwoman VELÁZQUEZ. Thank you. The gentleman yields back.

Now we recognize the gentleman from Pennsylvania, Mr. Evans, for 5 minutes.

Mr. EVANS. Thank you, Madam Chairperson. Thank you for your leadership on this issue.

The question I want to start off is with the professor from Georgetown. Mr. Levitin, can you describe the pros and cons of using FinTech for lending? What can business owners do right to now protect themselves from predatory lending? And I would like to get others to respond to that too.

Mr. LEVITIN. So, as Mr. Hiles was saying a second ago, FinTech simply—it is actually not a very useful term because it is so vague. It just means bringing technology to the lend—to financial services, and that can mean a whole range of things. In the lending context, it usually is used to refer to online lenders. But a website is hardly, you know, revolutionary technology at this point.

Often when we think of FinTech lenders we—people are referring to lenders that are using alternative underwriting data, so that they are able to maybe underwrite loans for borrowers that do not have traditional credit scores or have thin credit files, and also, lenders using particularly automated underwriting.

And these two things, the automated underwriting and the use of alternative underwriting data, enables both cheaper underwriting and faster underwriting, and underwriting of populations that might not otherwise be served by the traditional lending market.

Potentially, that is all really good, right. There is a lot of potential upside to FinTech. The problem is that FinTech has—it can be both good and bad, and you have—just as in the regular banking market, you can have abusive practices. You can have those, too, with FinTech.

And with FinTech lenders, often they are not operating with a banking license, so their regulation will vary. It is going to be on the State level primarily. And what that means they are actually subject to can just—there is substantial variation depending on how they do this.

Additionally, some FinTech lenders are not banks, but they partner with a bank. These bank partnerships are sometimes called rent-a-bank arrangements, where the bank acts as the front. It makes the loan and then immediately sells the loan, and the loan was made on spec for the FinTech. What that allows the FinTech to do, it allows it to evade State regulations.

So the example I give in any opening statement of the DeRamos' business loan, the 121 percent interest rate, well, Florida has an 18 percent usury cap. It actually applies—unlike many States, Florida's usury cap applies to business loans as well as to consumer loans.

How is a 121 percent APR loan made there? Well, because banks are exempt from State usury laws. And by having the little tiny Wisconsin community bank with just two branches in Wisconsin be the formal lender, and then a few days later, sell the loan to the FinTech, the FinTech was able to at least make an argument that it was not subject to the State's usury laws.

And, unfortunately, over the summer, the Office of Comptroller of the Currency and the Federal Deposit Insurance Corporation both put finalized rulemakings that pretty much blessed this process, and are giving a green light to bad actors in the financial services space rather than trying to, you know, squeeze out the bad actors and have an open field for the good actors.

Mr. EVANS. So maybe somebody can go real quick. I have a minute. So can I get you to respond the pros and cons on it?

Mr. LEVITIN. Can you repeat that, sir? I didn't hear it.

Mr. EVANS. Is anybody else giving comments on the pros and cons of FinTech along the panel?

Ms. URRUTIA. I would just say that FinTechs have done a great job of leveraging technology and data analytics to scale lending to underserved communities in markets where banks have left, and they have become banking deserts. And they have the reach and many are responsible.

The problem that we have as responsible lenders is with those online and FinTech providers that are not transparent in their disclosures. And with those who say that why don't we just talk about the cost of credit and the dollar amount, recognizing that that is not a good, fair comparison, because a 6-month loan is very different than a 5-year term loan, and so you have to look at APR in order to be able to compare apples to apples.

Mr. EVANS. I yield back the balance of my time.

Chairwoman VELÁZQUEZ. The gentleman yields back.

Now we recognize the gentleman from Oklahoma, Mr. Hern, for 5 minutes.

Mr. HERN. Thank you, Madam Chairwoman. I really appreciate you doing this meeting today, and Ranking Member Chabot, and our witnesses for testifying today.

As a business owner for over 35 years before getting into Congress 2 years ago, I am certainly very familiar with the complexities associated with obtaining access to capital through the loan programs that are out there and available.

I am also—as a cofounder of a small community bank, I also understand the compliance standards and the financial risk our lenders face on the other side. So I have a unique perspective of being on both sides of this for over 20 years now.

These financial risks have grown significantly, due to small businesses utilizing online lending more frequently, which often creates quicker means to obtaining loans, as each of you have described, is more appealing to younger demographics of business owners. If it is usually that easy and that automated, there is usually something of suspicion behind it, and I think that is what has been so appetizing about these type of loans.

Unfortunately, online lending comes with a lack of transparency and increased ambiguity regarding long-term agreements, again, as we have been speaking to today. Going forward, as our society's reliance on the digital marketplace continues, it is essential that we increase transparency so that small businesses better understand the terms of online lending agreements.

Compliance standards are also a growing problem, as our Nation's banks have been overregulated since the passage of Dodd-Frank, and they have become worse during the coronavirus crisis. While the PPP and auto programs have helped businesses remain open and for employees who are unemployed, a quick turnaround in processing these loans has placed even more standards on many banks, causing them to work extra hours and adding to the overall compliance cost.

So, to ensure more efficiency and transparency with SBA lending, we need to reduce the burdensome regulation for banks and strive to innovate. And this brings me to the first question.

Mr. Hiles, in your testimony, you note that the need for the SBA to be more innovative and work with technology companies to foster FinTech and RegTech solutions, if the SBA is to innovate through online platforms, how do we ensure that we are not overregulating causing more burdens for banks, yet also to ensure there is transparency for small businesses within loan agreements?

Mr. HILES. Madam Chairwoman, Representative Hern, thank you for the question. We are advocates of leveraging technology that exists today that allows for the immutable mathematical proof of documents and data. I think of it as the underlying technology beneath cryptocurrencies, but applied in an enterprise fashion for compliance purposes.

This allows a mathematical way to encrypt the information, and then decentralize it to, you know, essentially hack-proof it. I don't like to say that word because it is not true, but at least elevate a much higher level of security around that information.

This also provides for a proof of information and data from a regulatory standpoint as an examiner would be provided with a token key to the network to access specific records on a real-time basis. It would seem that from a transparency standpoint these kinds of innovations would be a dream come true for both small financial institutions who already struggle with technology innovation. As a community bank, they don't have the R&D budgets. And then from an administrative standpoint, to help leverage some of these new technologies, to also work in a far more efficient fashion as an administration. These are the kinds of things that we look forward to in the future with the ability to, you know, proof documents and data.

Mr. HERN. Thank you.

Mr. Levitin, my second question, I will start with you on this and we will see where time goes, but this is regarding increased lending flexibility for banks. What are some of the actions the government can take to reduce current regulatory burdens on banks to increase the flexibility within lending leading to quicker turnaround for loan processing, as that seems to be one of the appetizing things to the FinTech industry right now?

Mr. LEVITIN. So I am not actually aware of any particular regulation that slows down the speed of underwriting. There may be just internal technological and operating procedures that do so, but I am unaware of anything in terms of Federal regulation that requires a delay between when the bank decides to make a loan and when there can be a disbursement, or about how fast a bank can undertake an underwriting process.

There are certain things that, you know, pretty much any lender is going to be required to abide by, such as anti-money laundering regulations, but those should not be creating a particular delay once the necessary documents are submitted to a lender.

Mr. HERN. Madam Chairwoman, I yield back the balance of my time. Actually, I have none left.

Chairwoman VELÁZQUEZ. The gentleman yields back.

Now we recognize the gentleman from Illinois, Mr. Schneider, for 5 minutes.

Mr. SCHNEIDER. Thank you, Madam Chair. And thank you and the Ranking Member for hosting this important hearing.

I want to thank our witnesses for joining us today.

This summer, I had the privilege to host a number of virtual roundtables with, in particular, minority business owners in my district. And in these, time and again, we heard a common theme that these small businesses, especially minority-owned businesses, had nowhere to turn for financial assistance.

Now, the big businesses were getting ahead of them in line at the banks and accessing PPP, at least in the first round. Many submitted their paperwork, only to get skipped over, and they really struggled. In the second round, they did a little bit better.

But the data supports the conclusions. Only 12 percent of black and Latino business owners pulled between April 30 and May 12 said that they had received the funding they had requested, while about 1 quarter received some funding. In contrast, half of all small businesses reportedly receiving Federal reports through the PPP program.

So we passed PPP. We had additional help that we hoped to offer through the Heroes Act, but nothing has yet to come. And one of the biggest themes, or concerns I heard in these conversations, was the fear that nothing would come and they would be left hanging.

So my first question, and maybe I will start with Ms. Urrutia, is how successful do you think the second round of PPP funding was in targeting these underserved communities?

Ms. URRUTIA. [Inaudible] a lot of different places. Minority-owned businesses and the most vulnerable ones that we are talking about do not generally have banking relationships. As a result, the banks were only supporting their customers first. So that is why your comment that they stood at the back of the line, they stayed in the back of the line, for the most part.

Also, if you look at the average size of loans that were made, in the second round, it was $73,000. Our average loan size was $15,000, and we deployed about 1,000 loans in a 6-week period.

And so we must ensure that PPP funds go to the smallest, most vulnerable small businesses, because they are the ones that are minority-owned, and they are the ones that really need it, and that is why we are supporting that a second PPP loan be authorized.

We are also asking that PPP loans under $150,000, be automatically forgiven. Those businesses are the ones that need the most relief in order to get back on their feet.

And then, the other piece is an administrative fee. As you know, 5 percent was paid by SBA to loans under $350,000. In our case, we made a $15,000 loan. Five percent is $750. That does not cover the cost of processing the loans and working with these borrowers that need so much help to ensure that they can get approved.

Mr. SCHNEIDER. Thank you.

And maybe, because I think my next one is somewhat of an academic question, I will turn to Professor Levitin. But, you know, as we are looking forward, we are looking to the next package. In the minute and a half left, can you touch on, you know, the needs that businesses might have in the next round, how we could better structure this program to serve these underserved businesses, and what we might do also to create a more efficient, effective process to make sure these businesses have access to the loans?

Mr. LEVITIN. So, there is a bit of a MacGyver problem here where you have got to work with the tools you have at hand. We can't start setting up an entire new financial system from scratch.

Given the tools that are at hand, I think that PPP made the best of what it could from a bad situation. And while I am not generally enthusiastic about using—relying on private financial institutions to carry out Federal aid programs—I think we have seen problems with that in the past, for example, with mortgage servicers and Federal foreclosure relief—I think that, you know, the goal for the next round has to be figuring out a way that the banks that participate in PPP or any expansion of that will reach out not just to their existing clients, but try and serve new clients, and see this as an opportunity for developing new banking relationships.

Mr. SCHNEIDER. Great. Thank you.

And my time is expired, so I will yield back. But first, let me just, again, thank our witnesses today and thank the Chairwoman and the Ranking Member for this hearing.

Chairwoman VELÁZQUEZ. Time has expired. Now we recognize the gentleman from Minnesota, Mr. Stauber, for 5 minutes.

Mr. STAUBER. Thank you, Chairwoman Velázquez and Ranking Member Chabot. I really appreciate your leadership during this really difficult time for COVID-19, and the small business owners throughout the Nation, the 30 million of them.

Mr. Levitin, you just talked about the banking industry. You know, during this COVID-19, we have relied on our small community lending banks to, you know, help with these PPP loans with not a lot of help or guidance from the SBA at times, and I think they did a really good job under the circumstances. From your comments, I hope you agree with that. I think you stated that. Is that correct? Did I hear you correctly?

Mr. LEVITIN. [Inaudible] on the implementation of the PPP program to take a position there. So I just want to—I am going to say, my answer would be no comment.

Mr. STAUBER. Okay. And that is fine, because I want to put forth my congratulations and support for community banks and lending institutions that helped 51 million people keep their jobs and helped almost 10 million, 9-plus million businesses to stay open during this time.

And I would just say this, here is a question. The small businessmen and women across this Nation, they are the engine of our economy. The members of this committee understand that. I would ask anybody this question: Do you think, because small businessmen and women are the engine of our economy on Main Street America, is there anybody on the panel of experts here that feel there is a need for small businesses to be protected from COVID-19-related lawsuits? Anybody—this is directed to any one of the witnesses.

Ms. URRUTIA. Can you say more about—when you say protected from COVID-19 losses, what do you mean?

Mr. STAUBER. Lawsuits.

Ms. URRUTIA. Lawsuits.

Mr. STAUBER. Lawsuits.

Ms. URRUTIA. Okay.

Mr. STAUBER. Anybody? Any of the three witnesses?

Ms. TSHERING. Are you talking about lawsuits from employees or from, you know, customers or—yeah.

Mr. STAUBER. From the general public. Somebody comes in, you own a small business, you are following the CDC recommended guidelines. You have payments to make to the lending institutions that helped you get through, and there is a lawsuit—COVID-related lawsuit stating your business—I went into your business and got COVID. Tell me about your thoughts on that.

Ms. TSHERING. Yeah. So what we found is when we have asked our clients, you know, what sort of concerns do you have when you are operating your business, this is the last thing on their mind, you know, because they all have reopening plans; they, you know, have signs about masks, they have, you know, plastic barriers. That is the last concern on their mind.

Their concern is the rent they owe. And I think we had the professor also mention, we found that rent, you know, rent for the last few months, the debt that they have is the biggest concern among our small business owners.

And the other concern we have is, you know, hopefully there will be more relief for them. But we—you know, I manage a CDFI, and there are hundreds of CDFIs throughout the U.S.

Mr. STAUBER. So——

Ms. TSHERING. They should—you know, they could be funded—yeah.

Mr. STAUBER. Ma'am.

Ms. TSHERING. Yeah. Go ahead.

Mr. STAUBER. Let me ask maybe the question more directly. Is that something as a small business supporter, like you are, is that something you would support protecting the small businesses from these types of lawsuits? Because your experience where you are at, and my experience from talking to our Chamber of Commerces are much different. And so, I would say that it is a priority that when they open, when they follow the CDC guidelines that they aren't in lawsuits.

So I will be more direct: Do you support the protection, the liability for small businesses from lawsuits for COVID-19 only when they follow CDC guidelines? Anybody?

Yeah. So that is—your—the silence is deafening here, and that is the concern. That is the real concern we have across America. We talk about support for small businesses. Well, here is an opportunity to protect them. We have given our small businesses relief that they needed, in fact, the three-page PPP for those small minority-owned businesses that don't have a human resource department to be able to access there.

And so my question was, we are doing all this upfront. Do you know that of 30 million small businesses across this Nation probably 25 million, 28 million of the small businesses could not even handle one lawsuit?

So we know they are the engine of our economy, and it strikes me that all three of you are silent on my question.

Ms. TSHERING. So can we—yeah. We would like to give this more thought and get back to you, so we are very clear about what exactly you mean. And, you know, we appreciate your concern for small businesses, so we would like to get back to you on this.

Mr. STAUBER. I appreciate that. I am a small business owner for 31 years. And as Professor Levitin said, it is not easy, but we need that stability and the certainty to be able to even keep our doors open. And I think you would all agree with that.

I think that is—the last question I have, and I know I have a little bit of time here, are there any archaic laws that you see on the books that we should remove, that you as—from your expertise, that we should remove to help small businesses not only succeed, but also access to capital in an easier fashion like the PPP loans, the three-page loan to get that access to—that capital to the small businesses that need it? Anybody?

Mr. HILES. I will take that one very quickly. I think that Congress and the Securities Exchange Commission and, you know, the dialogue that is happening around equity funding is a positive step in the right direction with the realignment of what constitutes an accredited investor. I think that there needs to be more of a crowdfunding focused approach to some of the smaller businesses in particular.

That being said, even working with some of the Title 3 JOBS Act crowdfunding portals represents a pretty significant upfront, front-loaded expense to mount a marketing campaign and get through the statutory requirements in order to launch a crowdfunding campaign for even a very small amount of funding. Cost of capital tends to run fairly high.

Mr. STAUBER. Okay. Does anybody else want to tackle that one? Okay. I just——

Chairwoman VELÁZQUEZ. Time has expired.

Mr. STAUBER. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Thank you.

Now we recognize the gentleman from Tennessee, Mr. Burchett, for 5 minutes. You need to unmute yourself, sir.

Mr. BURCHETT. I think we skipped the order there. I think a Democrat should be next. I hate to cut in front of one of my colleagues across the aisle.

Chairwoman VELÁZQUEZ. No. I have recognized everyone.

Mr. BURCHETT. Oh, okay. So I am last. Oh, well, I should be more offended then. I apologize. I will remember that offensiveness to the next meeting. No, you are wonderful, Chairlady. I always enjoy being on with you, ma'am. I am sorry we are not in person.

I guess I am wondering about how do we increase our access—I am just going to ask all of the panelists there, if we can just start at one end and go to the other. How do we increase access to capital for business and limit our risk for lenders?

And I guess I would be interested really in our minority community. It seems like the percentage and the volume of loans go—it seems they are at a disproportionate amount, some of those folks, and I would be—I anxiously await your answers.

Ms. URRUTIA. I can start. I think a number of ways. First of all, make sure that CDFIs have the proper funding that they need. CDFIs are ensuring access to credit for impacted businesses in rural communities, underserved small businesses. We are offering affordable loans, technical assistance, and a lot of other services that are needed, and we need to be properly funded and have leverage and balance sheet capacity to support the lending.

So in support of CDFIs, a supplemental appropriation of $1 billion to the CDFI Fund will allow CDFIs across the country to leverage $12 billion in capital that will be deployed to communities in need. That is the first thing.

The second thing is make sure that section 1071 of Dodd-Frank is passed so that lenders report on the amount of lending that they are doing to minority and women-owned businesses. We need to have visibility so that we can understand what the problems are and correct them.

We also should be looking at reauthorizing the State Small Business Credit Initiative, SSBCI. After the Great Recession, this was a great program. It provided over $1.5 billion to State-led small business financing programs, and it gave a lot of flexibility to lenders to leverage that capital as loan loss reserves to support over $8 billion in small business loans.

So, I think that this is a great opportunity for public and private sector partnerships to come together through access to funding for CDFIs and loan loss reserves so that we can feel comfortable and continue to increase lending in these communities.

Mr. BURCHETT. Okay. Thank you. Anyone else?

Ms. TSHERING. So, you know, as a CDFI that works with minority and women-owned businesses, I would like to second what Luz just recommended about supporting CDFIs. And they are all, several hundred of them, or maybe even more than several hundred, spread all over the United States, rural, urban, you know, and they really understand the clients they work with, the businesses that need some hand-holding. And eventually, many of them are bankable and able to get larger loans from banks, so I really support that suggestion.

Mr. LEVITIN. I would also like to echo the point about section 1071 of Dodd-Frank. It is way past time for the Consumer Financial Protection Bureau to have implemented the data collection on small business lending, which is just the—it is the necessary precondition for trying to police the small business lending market for discriminatory lending. And without that data, it is just not easy to do any kind of meaningful fair lending enforcement.

Mr. BURCHETT. All right. I guess, Mr. Hiles, I will ask you the last question. I don't think I have got 30 seconds. But have the online lenders in the FinTech industry experienced a higher demand for capital from new businesses, and how is the industry managing the existing investments in companies that have made significant operational changes?

Mr. HILES. There has, indeed, been a significant growth. Thank you for the question, Representative, Madam Chair. There has been a significant growth in usability, and as I indicated in my initial testimony, we expect those numbers to continue to climb as the younger generation, who is far more transactional, less relationship-focused, wish to leverage the technology that has been in their hands since they were literally born as children to access all manner of capital.

And so, from that standpoint, we see there being nothing but a growth path forward for everything from online alternative lending to fully automated, full digital banking, and even non-lending banking as seen with some of the recent legislation in the State of Wyoming with special purpose depository institutions, you know, really remix the notion of what banking is from a services versus a lending-risk standpoint. Thank you for the question.

Mr. HERN. I yield back my time, Chairlady. Thank you, ma'am.

Chairwoman VELÁZQUEZ. The gentleman's time has expired.

Now we are going to go to a second round of questioning, and I welcome the members to stay on. I will recognize myself for 5 minutes.

Professor Levitin, last Congress, you testified before us on the Financial Services Committee on the use of the rent-a-bank scheme that allows FinTech lenders to get around state usury law. Can you explain the mechanics of those transactions to us, and how this scheme enables predatory lenders to continue operating unchecked?

Mr. LEVITIN. Absolutely, Madam Chairwoman. So every State in the country has some sort of usury law. They vary substantially—but here is the basic thing you need to understand about them: Banks are not subject to State usury laws. I put in a little asterisk. It is a little more technically complicated, but that is the basic takeaway. Banks are not subject to State usury laws. Nonbanks are subject to State usury laws.

In a rent-a-bank arrangement, a nonbank will partner with a bank, and here is the terms of the partnership: The bank will make loans according to the specifications of the nonbank. It may even use an underwriting platform that is licensed to it by the nonbank, where basically the nonbank has done all the programming and has set all the terms of the underwriting.

The nonbank will do the marketing, it will service the loans, and it will also purchase the loans or purchase an economic interest, such as a participation interest, in the loans from the bank, so that all the bank is really doing is being an origination agent. Its name is on the loan documents originally. And maybe it provides very—you know, the original funding for a very short period of time. Maybe it holds a 10 percent or 5 percent economic interest in the loans going forward.

But for all real purposes, the nonbank is the lender, and it is using the bank as a front to make the loans. And the reason it does that is because then that gives it a legal argument, which is a contested one, but it gives it a legal—it gives the nonbank a legal argument that the bank is the true lender, and that, therefore, the loan is not subject to State usury laws, and that the nonbank is not subject to State licensure requirements, and that the loan is not subject to other State consumer protections, such as limitations on rollovers, in the case of payday loans.

Chairwoman VELÁZQUEZ. How does the lack of federal regulation allow this practice to continue unchecked?

Mr. LEVITIN. Well, historically, if you went back about 17 years, in 2003, the Office of Comptroller of the Currency cracked down on these kind of arrangements, which were being used by online payday lenders. And the Office of Comptroller of the Currency stopped every national bank that was involved in doing this kind of rent-a-bank from doing this.

A few years later, the FDIC stopped all the State-chartered insured banks from doing this. I was actually an expert witness for the FDIC in some litigation about this.

We have since had a change in management at the OCC and FDIC, and the change in view about the dangers of predatory lending. And the OCC and FDIC have intervened in usury litigation to try and protect rent-a-bank schemes.

And this last summer, they both finalized regulations that—and I emphasize these regulations have already been challenged by the Coalition of State Attorneys General, but these regulations, if upheld, will basically bless this kind of rent-a-bank arrangement.

And they say if the bank's name is on the loan, it doesn't matter what the real facts are, it doesn't matter that the bank did absolutely nothing with the loan, we are going to treat it as a bank loan.

Chairwoman VELÁZQUEZ. Thank you.

Mr. LEVITIN. And that just allows the banks to rent out their Federal regulatory privileges, which isn't how the system should work.

Chairwoman VELÁZQUEZ. Thank you. Thank you very much.

Ms. Tshering, as someone who played a key role in the push for New York's TILA for Small Business that awaits Governor Cuomo's signature, I just want to ask you, what are some of the hallmarks of the New York legislation that you think must remain in any federal legislation?

Ms. TSHERING. Well, one thing for sure, something we have been—you know, each witness has said over and over again, you know, very important that we are able—you know, a borrower is able to compare apples to apples. So key is the APR, so they are able to see what the loan is going to cost. The second is, you know, no prepayment penalties.

What we are asking for asking for is transparency. And as you, and earlier, Ranking Member Chabot referred to, you know, we are talking about business owners. This is an opportunity for them to build assets and wealth. But what happens is when they take on these loans, which are, you know, not very clear about what the costs are involved, then they are really stripped of their assets.

Chairwoman VELÁZQUEZ. Thank you.

Ms. TSHERING. So what we are asking for is very simple: We are asking for transparency and clarity.

Chairwoman VELÁZQUEZ. Thank you. Thank you. My time has expired. Now I recognize the Ranking Member, Mr. Chabot, for 5 minutes.

Mr. CHABOT. Thank you, Madam Chairman. Thank you.

And I will go to Mr. Hiles. Mr. Hiles, as you know, a number of FinTech companies did participate in the PPP program, the Paycheck Protection Program. Moving forward with respect to the SBA and their other existing programs, like the 7A loans program, the 504 loan program, the microloan program, those types of things, how do you see FinTech now fitting into those programs in the future? And how would you like to see, you know, that relationship progress, FinTech and the SBA?

Mr. HILES. Chairwoman, Ranking Member Chabot, thank you for the question, and that is a good question. A couple of things. One is that, as I stated in my initial testimony, that SBA is going to continue to be subjected to the—call it idiosyncrasies and the disruption that is taking place in the financial institution, and the financial services market right now for those myriads of market forces and technology reasons.

The opportunity to define standards first as opposed to being necessarily highly prescriptive about the technology but then working with the—not only the financial institutions, but the technology providers and the folks that build technology, to innovate and come up with new solutions that would optimize the management of the documents and the data and all of the loan applications, the borrowing applications, you know, all of the TRID compliance, everything that goes along with these loans from a documentation standpoint, but then optimize and bring a high degree of efficiency and optimization as an administration, and then be a leader that sets the standard forth about those programs beneath which the FinTech industry, and then ultimately, the traditional financial services industry, can follow suit and operate.

If you are looking for the private sector to establish these kinds of standards and then adopt them, I think that we have leaked pretty far in terms of technology innovation and where we are at, and we are scrambling to figure out how to incorporate that into traditional organizations.

And now is a time for leadership. And much like the Federal Government established the standards that ultimately became the internet and the world wide web, we are in the throes of potentially doing the same with finance and financial records. And so, I would highly admonish the stakeholders across the board to consider this type of opportunity right now with the industry.

Mr. CHABOT. Thank you.

And then, finally, as Congress continues to examine the role of your industry, FinTech companies, do you have any recommendations for us? And, you know, especially relative to regulations, you know, more regulations versus the trend that we have tried to establish in government in recent years is to reduce unnecessary regulations or duplicative things, you know, so we don't kill the goose that laid the golden egg here for the economy and otherwise. So do you want to weigh into that with the additional time I have available to you here?

Mr. HILES. Certainly. Thank you. There would be a couple of key areas. One of the things that we like to do is we like to start with the regulation first, and then work our way backwards into the technology itself. And I think that there is this resistance to technology in general. It is frightening. It is hard to understand. And the idea that people are using technology to necessarily skirt the regulations isn't necessarily true. Once again, it goes back to those standards.

I have seen some interesting things coming out of OCC and interim Director Brooks talking about how payment providers would ultimately end up with some form of de facto charter. I know that that has raised a lot of red flags with banking—you know, division of bankings with the States already.

So it is going to be an interesting dynamic to see how we get there in terms of getting past the logjam that exists with banking and tech now. Do we leapfrog it forward with technology companies that become financial institutions? Not real sure at this point.

But Congress does absolutely have an opportunity to lead the discussion as opposed to being responsive and waiting for the— hopefully, you know, at some point, there would be a solution, but historically, that has tended to be not necessarily the case when it comes to standard setting, and that is where I believe the Small Business Administration has the opportunity to really drive this conversation forward.

Mr. CHABOT. Thank you very much.

And, Madam Chair, I think my time is expired, and I do have a 3:00 commitment, so I will be dropping off shortly.

Chairwoman VELÁZQUEZ. Yes.

Mr. CHABOT. But I thought this was an excellent hearing. I want to thank all the witnesses for their fine testimony. I yield back.

Chairwoman VELÁZQUEZ. Thank you. The gentleman yields back.

Now we recognize the gentleman from Pennsylvania, Mr. Evans, for 5 minutes. You need to unmute.

Mr. EVANS. Okay, Can you hear me now?

Chairwoman VELÁZQUEZ. Yes, we can hear you.

Mr. EVANS. Yes. I just want to follow up to something that the Chairwoman was talking to the professor regarding what you described about State policy and Federal policy. How do financial technology leaders ensure compliance with equal credit opportunities and unfair banking rules? Is what I heard in the discussion you were having with the Chairwoman, is that the same situation?

Mr. LEVITIN. No, that is not. So there is no—the rent-a-bank situation does not enable nonbanks to evade fair lending laws. They are still subject to—whether it is the bank or the nonbank partner, someone there is subject to fair lending laws. The problem on the fair lending side is that the—that if you want to do fair lending enforcement or looking for disparate impact, you need to have data.

And section 1071 of the Dodd-Frank Act enacted a decade ago calls for the collection by the Consumer Financial Protection Bureau of data on small business lending. Unfortunately, the Consumer Financial Protection Bureau has not yet implemented the regulations necessary to effectuate that, so we don't have any data being collected.

I would suggest that, you know, at least a temporary stopgap measure would be for any further Federal assistance that is given out under, sort of, additional—I am not sure what we are going to call it—CARES Act round 2 or what have you, HEROES Act, any additional—that there be requirements that lenders start collecting and submitting data on the race, the ethnicity, and the gender at least of the parties that are assisted, so we have a better understanding of where money is flowing and making sure that it is being made available equitably to everyone in society.

Mr. EVANS. Thank you.

And I yield back the balance of my time. Thank you, Madam Chairperson. Thank you for your leadership.

Chairwoman VELÁZQUEZ. Thank you. The gentleman yields back.

Let me thank all of our witnesses today for their testimony. We have explored some of the risks FinTech lending presents for small businesses, and also some of the benefits. It has become clear to me that there is a way to leverage those benefits, greater speed, affordability, and accessibility, and translate them into gains for small business owners.

Also, we have heard from lenders who can sustainably make these loans, create the partnerships necessary to bring the mission-based lending model online, and help the small businesses grow and create jobs without resorting to deceptive or abusive practices.

However, it also remains clear to me that much more needs to be done in this space to eliminate unfair and abusive practices by predatory lenders who have no interest in helping small businesses grow or helping a community flourish, only to enrich themselves at the cost of the small businesses.

Congress must follow the lead of New York and California who are actively working to ensure a safe, fair, and affordable small business lending market.

I ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

If there is no further business before the Committee, we are adjourned.

[Whereupon, at 2:55 p.m., the Committee was adjourned.]

APPENDIX

ACCION | Opportunity Fund

TESTIMONY BEFORE THE UNITED STATES

HOUSE COMMITTEE ON SMALL BUSINESS

BY

LUZ URRUTIA, CHIEF EXECUTIVE OFFICER

ACCION OPPORTUNITY FUND AND OPPORTUNITY FUND

ON

SEPTEMBER 9, 2020

Good afternoon Chairwoman Velázquez, Ranking Member Chabot, and Members of the Committee.

I am pleased to join you today to discuss the need for transparency in the small business lending marketplace. My name is Luz Urrutia, and I am the CEO of Accion Opportunity Fund and Opportunity Fund.[1] Opportunity Fund is a Community Development Financial Institution (CDFI) and the nation's leading nonprofit microlender to small businesses. I have served as an expert in small business and consumer finance on a number of government-appointed boards and commissions, including the Consumer Financial Protection Bureau (CFPB) Consumer Advisory Board and the Consumer Advisory Council of the Federal Reserve Bank. My entire career has been focused on financial services, with the bulk of my experience devoted to serving underserved populations across all parts of society - from unbanked/underbanked immigrants, to the previously banked, to small business owners. From my experience, leveraging data analytics and technology are critical to expanding access to responsible and affordable financial products for underserved small businesses and positively impacting customer behavior.

At Opportunity Fund, we believe that small amounts of money and the right financial advice can help people make permanent and lasting change in their own lives—driving economic mobility and building stronger communities. Our strategy combines microloans for small business owners with New Markets Tax Credit (NMTC) investments in high-impact community infrastructure projects. Last year alone, we deployed nearly $120 million in capital to over 3,200 small businesses loans across the nation.

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[1] McShane, Caitlin and Katie Mounts, *Opportunity Fund and the Accion U.S. Network Combine Efforts to Drive Small Business Access to Credit and Advisory Services in the U.S.*, March 11, 2020: https://www.opportunityfund.org/wp-content/uploads/2020/03/Accion-Opportunity-Fund-Combination_Press-Release_FINAL-1.pdf

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The financing gap for American small businesses is immense and growing. Prior to COVID-19, small businesses, primarily minority, immigrant, low-to-moderate income and women-owned, were already facing significant challenges when trying to access responsible and affordable capital. The small dollar lending market gap for small businesses was estimated at $87 billion for loans less than $100,000. Mainstream financial institutions do not generally lend to underserved small businesses for a variety of reasons–credit boxes, size of loan, industry, profitability, etc.

In place of lending directly to small businesses, banks prefer to provide lines of credit to CDFIs, such as Opportunity Fund, under the Community Reinvestment Act (CRA) and, in turn, we do the lending.

Since the Great Recession many banks left communities, and online lenders–some responsible but many bad actors–stepped in to fill the gap left by the banks. Post-COVID, the lending landscape will be dramatically altered. Banks will further tighten their credit boxes and reduce their appetite for risk, and many for-profit, non-bank lender Fintechs and Merchant Cash Advance providers will retrench or fail due to their own capital structures and increased portfolio losses. A number of online lenders have already been acquired by other organizations and there are probably more acquisitions of Fintechs in discussion. The result will be that underserved small businesses that already faced significant challenges accessing responsible capital will have an even bigger struggle to access capital to help them weather the storm that is COVID-19.

To meet this significant capital need, Opportunity Fund believes that we must continuously innovate and collaborate with other responsible Fintechs in the private sector, along with our nonprofit community partners, to bring access to responsible capital to entrepreneurs across the United States. One of the ways we do this is through our partnership with LendingClub and Funding Circle—two leading Fintech lenders—to increase small business owners' access to transparent, affordable, and responsible credit. We are also founding members of the Responsible Business Lending Coalition (RBLC), a coalition of nonprofit and for-profit lenders, investors, and small business advocates that share a commitment to transparency and innovation in small business lending. I want to thank the Chairwoman for introducing the Small Business Lending Disclosure and Broker Regulation Act of 2020, which will bring protections from irresponsible lending practices to small businesses across our nation.

Why transparency in lending matters

Individual consumers are protected by the Truth in Lending Act, which requires transparent disclosure of loan terms, fees and annual percentage rates (APR) of loans. Small businesses,

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however, are not covered by this law, leaving them vulnerable to misleading or irresponsible lending practices.

Opportunity Fund has analyzed a detailed dataset of alternative loans held by small business owners who came to us in hopes of refinancing.[2] We found that the unregulated lenders we studied were charging an average APR of 94%, with an average monthly loan payment that was nearly double the borrowers' net incomes. One loan was priced at an astounding 350% APR. The short terms and extraordinary high costs of these loans put many small business owners in a crushing cycle of debt.

Take for example Deanna Irish, owner of Wine Tour Drivers in Sacramento, California. Deanna took a $25,000 online loan which ended up costing her $2,000 a month due to the exorbitant fees associated with the loan. To get out from under the crushing debt, Deanna was able to refinance with Opportunity Fund, which cut her payment from $2,000 a month to $900. She has since been able to completely pay off the loan with us.

These high rates paid by entrepreneurs are not only unfair, they are also often hidden under layers of misinformation—if disclosed at all. Federal Reserve research finds that small businesses are often misled by disclosures quoting non-APR rates.[3] The inability to compare prices on an apples-to-apples basis stymies free market competition that could lower prices and spur financial services' innovation. Transparency in commercial financing would help level the playing field for American entrepreneurs.

Right now, in the face of a public health and economic crisis sparked by COVID-19, small businesses are in peril. This transparency could not come at a better time. According to the National Bureau of Economic Research, 2.2 million small businesses closed between February and May. Black, Latinx and immigrant-owned businesses bore the brunt of the pain.[4]

In addition, staffing firm Homebase found that the recovery that began in April essentially flat-lined in August with more than 20% of small businesses across the nation remaining

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[2] Weaver, Eric, Gwendy Donaker Brown, and Caitlin McShane, *Unaffordable and Unsustainable: The New Business Lending on Main Street*, Opportunity Fund, May 2016: www.opportunityfund.org/wp-content/uploads/2019/09/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

[3] Federal Reserve Board, *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*, 2019: www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

[4] Fairlie, Robert, *THE IMPACT OF COVID-19 ON SMALL BUSINESS OWNERS: EVIDENCE OF EARLY-STAGE LOSSES FROM THE APRIL 2020 CURRENT POPULATION SURVEY*, National Bureau of Economic Research, June, 2020: https://www.nber.org/papers/w27309.pdf

shuttered. And according to data from Drexel University,[5] small businesses with 50 employees or fewer lost nearly 18 million jobs between mid-February and mid-April, a 60% decline. Close to half of these jobs returned as states began to re-open, but then recovery stalled in mid-June. Indeed, reports show[6] that when the pandemic eventually subsides, roughly one-third of New York City's 240,000 small businesses may never reopen.

As business owners search for ways to remain solvent, an uninformed financing choice could be the difference between survival and failure. For minority-owned, immigrant-owned, and smaller businesses who disproportionately apply for online financing, they would benefit the most from the ability to properly comparison shop.

The need for national legislation

Small business lending transparency is fundamental to the health of our economy and our recovery from this crisis. Opportunity Fund proudly endorses the Small Business Lending Disclosure and Broker Regulation Act of 2020, and we applaud Chairwoman Velázquez for her leadership introducing this legislation, which will bring common-sense transparency standards to small business financing in the United States. In fact, we project this bill will bring over $3.8 billion in savings for nearly 800,000 small businesses annually[7], including hundreds of millions in savings for over 158,000 minority-owned small businesses.

California and New York have already passed legislation mandating transparency in small business lending. These efforts should be applauded and should inform legislation at the national level. However, a piecemeal, state-by-state approach hampers innovation and our small business-driven economy. We need clear and consistent regulations across the country that protect all our small businesses equally and allow responsible lenders to innovate and create quality products and services. I encourage all of you, and our leaders in Congress, to work together to pass the historic Small Business Lending Disclosure and Broker Regulation Act of 2020.

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[5] Kurrman, Andre, *The Impact of COVID-19 on Small Business Employment and Hours: Real-Time Estimates with Homebase Data*, Drexel University, Aug. 5, 2020: http://www.andrekurmann.com/hb_covid
[6] Wylde, Katherine and Natasha Avanessians, *A Call for Action and Collaboration*, Partnership for New York City: https://pfnyc.org/wp-content/uploads/2020/07/actionandcollaboration.pdf
[7] Responsible Business Lending Coalition, *Responsible Business Lending Coalition Endorses Small Business Lending Disclosure and Broker Regulation Act*, July 30, 2020: http://www.borrowersbillofrights.org/rblcendorsessblendingandbrokerdisclosureact.html

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California Commercial Financing Disclosures - SB 1235

Approved with bipartisan support in 2018, SB 1235 was a first-in-the-nation truth in lending law for small businesses, and a significant step toward protecting California business owners from predatory lending practices. This law generated great momentum, which we are now seeing come to fruition both in New York and at the federal level.

Once fully implemented, SB 1235 will dramatically increase the transparency of financial products marketed to small businesses. We estimate that among the one million California small businesses that apply for capital annually, the approximately 400,000 who apply to online lenders will benefit the most, as they are more likely to receive non-transparent disclosures and overpay for credit.[8] Both Opportunity Fund and the RBLC have worked tirelessly for the last two years to help inform the disclosure standard-setting process mandated by SB 1235.

New York Small Business Truth in Lending Act - AB 10118 / SB 5740

In July of this year, the New York State Legislature passed legislation, building on California's SB 1235, to require clear and comprehensive disclosures from all commercial lenders. These requirements will allow small business owners to easily compare financing offers and make the best financial decision for their business at this critical time when small businesses need protection the most. The legislation is awaiting Governor Andrew Cuomo's signature. Once implemented, we estimate New York small business owners will save between $369 million and $1.75 billion annually.[9]

Effective deployment of fintech solutions - one example

The ease of application, use of data analytics and digital reach of Fintechs hold much promise for expanding access to affordable credit for small businesses—if it is done in a transparent and responsible manner. For example, as mentioned earlier, Opportunity Fund launched a partnership with LendingClub, America's largest online credit marketplace connecting borrowers and investors, and Funding Circle, the nation's leading small business loan platform. Our goal is to

[8] In January, 2020 RBLC submitted this letter to the CA Department of Business Oversight on the economic impact of implementing this law.

[9] McShane, Caitlin, Responsible Business Lending Coalition, The Responsible Business Lending Coalition Applauds the Passage of New York State's Small Business Truth in Lending Act, July 24, 2020: https://www.prnewswire.com/news-releases/the-responsible-business-lending-coalition-applauds-the-passage-of-new-york-states-small-business-truth-in-lending-act-301099503.html

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substantially increase small business owners' access to transparent, affordable, and responsible credit.

Through this partnership, LendingClub connects applicants looking for a small business loan on its platform to Opportunity Fund. Opportunity Fund leverages LendingClub's robust marketing efforts to acquire customers and Opportunity Fund uses its technology, data analytics and risk management to provide pre-qualified offers to underserved small businesses. For small businesses that need greater than $100,000 or are Prime creditworthy customers, Opportunity Fund refers those borrowers to Funding Circle. This partnership has expanded efficient access to affordable credit to a much broader range of small businesses across the country that none of our three organizations could have funded on our own. Together, we have increased access to capital by delivering funding quickly to small business owners who may have been shut out by the traditional financial system or may have resorted to very high-cost loans —mostly businesses owned by minorities, women, and immigrant entrepreneurs—all with good repayment rates.To date, this partnership has generated nearly $75 million in loans to over 2,100 small businesses.

One such small business owner who benefited from this new partnership is Nick Christo, the co-owner of My City Social, an online advertising and marketing firm based in Orlando, Florida. Nick borrowed from a few different alternative online lenders. The last one was so expensive it led him to search for a way out of a substantial debt load - and that's what brought him finally to Opportunity Fund, through our partnership with LendingClub. We refinanced that debt over a longer term, bringing monthly payments from $17,000 down to $5,000, which gave Nick's business back the cashflow it needed to continue operating.

As mentioned above, we strongly believe that the lending landscape will change dramatically post-COVID-19. Banks will probably take a more conservative approach to lending to many small businesses than pre-COVID. Many Fintechs and merchant cash advance firms may not survive because of their loss of clients and loan portfolio losses, leaving an even bigger gap for affordable and responsible capital available to underserved communities. Those that do survive and new entrants must be held accountable to treat their customers responsibly.

Because CDFIs are already reaching these underserved small businesses in rural and urban communities, we should be ready to step in to fill this bigger capital gap and also provide technical assistance and other services they will need. That's why it's imperative the CDFI industry be financially strong to help rebuild Main Street and revive the economy.

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Broader capital support for small businesses

Lending transparency laws are a crucial step in supporting American small businesses, but they are only one piece in a set of necessary reforms to support a thriving small business sector. There are a number of other small business priorities and public-private sector partnerships that need attention from Congress. Namely:

Fully implementing Section 1071

While we know that small businesses need more transparent and affordable access to capital, what's less clear is exactly how capital needs for small businesses are currently being met and where the financing gap is most pronounced. The post-financial crisis retraction in business lending by banks created a market gap that has been filled by a variety of lenders—but there is no industry-wide dataset with which trends can be measured, practices can be analyzed, and key gaps can be identified and addressed. Initial results from Paycheck Protection Program (PPP) lending strongly indicate that entrepreneurs of color are not being well-served by mainstream institutions.

Section 1071 of the Dodd-Frank Act mandates that the Consumer Financial Protection Bureau collect data from providers of small business financing to create an ongoing, industry-wide dataset. Implementing Section 1071 would help create clear standards and provide a better understanding of the small business lending landscape. With this data, the CFPB could pinpoint key gaps in the market, connecting the right lenders with the right customers, and vice versa. This will drive competition and innovation in the market. In other words, Section 1071 is good for both industry *and* the small businesses we serve.

We can't truly know how to help those who are being left behind if we are not collecting data. The costs to fully comply and report under Section 1071 will be minimal as most lenders already collect a number of the proposed data points. Some may argue that data collection is burdensome and difficult. However, there are numerous examples of thriving markets in which financial institutions collect and report comparable information on a regular basis. For example, despite limited resources, nonprofit CDFIs across the country, including ours, collect and report data about our lending and customers to the CDFI Fund with the Department of the Treasury on an annual basis. Information reported includes transaction-level data such as amounts, terms and pricing as well as demographic information from small business borrowers, all in full compliance with lending regulations. If non-profit CDFIs can collect this type of data, the rest of the industry can certainly do this, too.

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Allocating $1 billion in emergency funding to the CDFI Fund

CDFIs ensure access to credit for impacted businesses, nonprofits, and individuals in our nation's low-income communities. As mission-driven organizations, CDFIs offer affordable loans, technical assistance, and other much-needed services to those who cannot find support elsewhere. Opportunity Fund, like many other CDFIs, is actively working with funders, investors, and the government to secure additional funding so that we can properly assist existing and new clients during the current crisis. However, much more is needed.

A supplemental appropriation of $1 billion to the CDFI Fund will allow CDFIs across the country to leverage $12 billion in capital that will be deployed to communities in need. This approach has been proven to work and is inline with the supplemental funding approved in 2009 through the American Recovery and Reinvestment Act, which allowed resources to be deployed quickly to CDFIs operating in low-wealth communities across the nation. This is a bipartisan-led effort as shown in the most recent Senate sign-on letter in support.

Extending and Improving the Paycheck Protection Program (PPP)

As a PPP lender, we had the opportunity to work with small business borrowers directly and would like to provide feedback on enhancements to the program so that small business owners can better benefit going forward.

First, we must ensure remaining PPP funds go to the smallest, most vulnerable businesses. The program should allow very small businesses, many of whom are minority-owned, to take out a second PPP loan, if needed. Second, PPP loans under $150,000 should be automatically forgiven, as they represent the smallest businesses that qualified and applied for aid. These businesses are the ones that need the most relief in order to get back on their feet. Finally, a minimum administrative fee of $2,500 should be paid to PPP lenders on all PPP loans. Currently, the Small Business Administration (SBA) pays lenders 5% in fees for loans under $350,000. Loans under $50,000 would receive less than $2,500. For example, Opportunity Fund's average PPP loan is $15,000 and the average fee is $750, an amount that doesn't cover the costs of processing these loans and working with the borrowers to ensure they can get approved. A minimum administrative fee of $2,500 would make it so that more lenders are willing to make smaller loans, thereby increasing access to capital to the smallest and most vulnerable businesses.

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Reauthorizing the State Small Business Credit Initiative

After the Great Recession, the State Small Business Credit Initiative (SSBCI) provided nearly $1.5 billion to state-led small business financing programs with significant flexibility that promoted responsible lending and met local market needs. The program supported nearly $8.4 billion in new small business loan capital and investments, which allowed each public dollar to be leveraged with more than $5 in private sector capital.

Reauthorizing the program, with improvements, would allow states and responsible lenders to better serve more of the most vulnerable small businesses as our economy recovers, especially those hardest hit by COVID-19.

Closing

We believe lending transparency is vital to the success of American small businesses, and thus to our besieged economy. Transparent and responsible financing is not only vital to small business borrowers, it also encourages fair pricing and innovation in the lending market. Importantly, transparency in lending levels the playing field for the businesses that are most vulnerable—low-income, minority-, veteran-, or women-owned businesses that often cannot rely on traditional lenders for accessing capital.[10]

We urge the members of this Committee to continue demonstrating leadership on behalf of our nation's small business owners by supporting the Small Business Lending Disclosure and Broker Regulation Act of 2020 and taking up the other recommendations presented here today.

Thank you.

[10] US Government Accountability Office, *SBA MICROLOAN PROGRAM: Opportunities Exist to Strengthen Program Performance Measurement, Collaboration, and Reporting*, Nov. 2019: www.gao.gov/assets/710/702731.pdf

BUSINESS CENTER
FOR NEW AMERICANS

Transparency in Small Business Lending

Testimony before the

U.S. House of Representatives

Committee on Small Business

September 9, 2020

Submitted by:

Yanki Tshering

Founder and Executive Director

Business Center for New Americans

New York City, New York

Chairwoman Velazquez, Ranking Member Chabot, and distinguished members of the Committee, good afternoon. Thank you for inviting me to speak with you today about the lack of transparency in small business lending, and the urgent need to provide entrepreneurs with the information they need to make informed financing decisions.

My name is Yanki Tshering and I am the Executive Director of Business Center for New Americans (BCNA). BCNA is a Treasury-certified Community Development Financial Institution (CDFI) and Small Business Administration (SBA) Microlender and Community Advantage lender based in New York City. BCNA was founded to help hardworking immigrants and refugees pursue the American dream. For over two decades, we have provided financial counseling and loans to help clients start or grow a business, buy a home, or save for the future.

In addition to my role leading BCNA, I have also served on the board of the New York State CDFI Coalition since 2015. This coalition strives to efficiently and effectively support the 80 CDFIs in New York State so that they can in turn ensure access to capital for individuals to achieve their financial goals and also serve the needs of their communities.

Background on BCNA

BCNA's mission is to create pathways to self-sufficiency for immigrant and refugee entrepreneurs in New York City by providing access to affordable credit, empowering them with financial education, and offering training in best business practices and technology.

Each year, BCNA is approached by approximately 8,000 refugees and immigrants who seek microloans and advice on how to start or expand micro and small businesses. Approximately 10% of them go on to become our loan clients, or receive technical assistance delivered through one-on-one sessions or group workshops. Many prospective clients learn through discussions with BCNA that they are not yet ready to start a business and may return to us in the future once they have taken steps to prepare.

Our micro and small-business clients range from the street vendor who comes once a year to borrow $500 to fund his inventory of roses for Valentine's Day, to the deli owner client with 6 stores and 80 employees.

Target clientele are groups with proven barriers to access resources in the mainstream financial marketplace: new immigrants, refugees, aspiring minority and women entrepreneurs, low-income people and low-wealth businesses. BCNA clients are unable to secure loans from traditional banks due to credit issues, length of time in business, or size of loan request. While we make loans up to $250,000, many requests are for loans that range from $500 to $5,000 that are not profitable for banks to make and therefore not available from traditional financial institutions. Often these clients do not have the credit history required to qualify for a loan. More often than not the loans that we provide, help our clients establish credit history and eventually they may qualify for a line of credit or another loan product from a bank. The provision of training and education on establishing a credit history and one-on-one assistance takes time and effort that are not cost effective for banks. In fact, a number of banks have supported us so that we could increase our capacity to provide credit builder loans and workshops to educate clients about establishing positive credit history.

In keeping with historical trends, 95% of 2019 borrowers were refugees or immigrants. They hailed from 55 countries and 62% were women. Most are of modest means: 93% low-income (earning 80% or less of Area Median Income or AMI); this included 31% in the very low-income subset (30% to 50% AMI) and 41% extremely low-income (< 30% AMI). At $34,800, median borrower household income was just over half the NYC $60,762 benchmark.

BCNA serves exceptionally diverse clients:

•Formal education from elementary school to PhDs

•Professional and vocational backgrounds include physicians, lawyers, attorneys, accountants, farmers, musicians, hair braiders, and nomads

•Countries of origin from Azerbaijan to Zambia- currently many from western Africa, former Soviet Union, south Asia

•Languages include Spanish, Russian, French, Bangla, Urdu, Nepali, Tibetan, Arabic, many African dialects

•Ages 19 to 70 (most 22-49 years)

•Over 90% identify as part of minority groups

In line with this diversity, in 2019 BCNA loans supported businesses in 26 distinct market sectors including car/taxi services, day care centers, grocery and retail stores, legal and medical providers, food carts, restaurants and beauty salons. Most clients live in economically distressed and highly distressed communities. Many also operate their businesses in distressed areas ensuring underserved communities have access to the types of food, retail goods and services that contribute to a higher quality of life.

Named a top 10 U.S. microlender by CNN Money and a top SBA microlender in NYC for 10 years, BCNA is the second most prolific SBA microlender nationwide and an Aeris-rated CDFI (A- 3-star rating) affirming strength of the business model. Aeris provides CAMEL-like financial and impact performance analysis of CDFIs for investors. BCNA has made over $ 32 million in micro and small business loans to businesses in New York City and provided training and advice to over 10,000 businesses.

One of those 10,000 businesses is Vladimir Teriokhin, the owner of Haute Knit which produces knitted garments for New York design houses. He was initially ecstatic when he was approved for a $35k loan from an alternative lender found online, but gradually realized to his horror that they were deducting daily repayments of $268 from his bank account and he was paying over 61% in annualized interest. Vladimir came to BCNA and we were willing to provide a loan so that he could pay off this high interest loan. We were then shocked to learn that all interest and fees were required to be paid for the full amount even he was able to pre-pay this loan.

The Need for Small Business Lending Transparency

Now, more than ever, small businesses in New York and across the country are suffering from a lack of access to responsible credit – a problem that has been exacerbated by the lack of transparency requirements for financing providers. The Truth in Lending Act, originally passed in 1968, requires lenders to clearly disclose their pricing and terms to consumers but does not apply to financing for commercial purposes. This simply means that small business owners like Vladmir are left to face a Wild West of unregulated and increasingly complex financial products without any consistency in how the lenders explain or present their products to borrowers.

Larger, more established businesses may be able to hire an attorney who can translate confusing term sheets into digestible language so the entrepreneur can truly understand what is being offered to them and make an informed decision. However, as members of the Committee know very well, the overwhelming majority of small businesses are quite small, having 20 or fewer employees.[1] The businesses BCNA typically serves are family owned and operated micro and small businesses, and the majority of them come to us to get credit up to $50,000, as they cannot access this financing from banks.

We regularly assist clients who have encountered alternative loan products such as merchant cash advances (MCAs) that they did not understand – at times, with dire consequences.

Transparency Problem #1: Alternative "Rates" That Appear Inexpensive

Many alternative lenders including MCAs disclose a "simple interest rate" or "fee rate" that looks like a standard annual percentage rate (APR), but is not.[2] These "rates" give small business borrowers the impression that the products are inexpensive, when in fact the true APR is quite high. Confusion presents a significant problem, especially for the low-income immigrant and refugee populations we serve, because in the end they simply cannot afford the high cost of these products. Business owners take out these loans thinking they are getting a good deal, but are quickly unable to keep up with expensive daily or weekly payments that put everything they have built at risk. A loan that lacked clear APR disclosure put Valdimir into a debt spiral; before long he was using all his credit and incurring more debt to keep up with the daily payments that were stripping assets from his personal and business accounts.

Transparency Problem #2: Renewals

While MCAs often have 6-18 month original repayment terms, MCA companies frequently encourage their borrowers to "renew" or refinance partially-repaid debt with some additional

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[1] https://www.census.gov/programs-surveys/ase/data/tables.html

[2] https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

cash out. What MCAs do not disclose is that the borrower must pay full finance charges twice on the unpaid balance that is carried over into the renewal. Borrowers often do not understand the structure of the renewal until they discover that they have only received a small amount of additional funds, and that a large portion of their new loan has gone to cover the duplicate finance charges.[3] It is important that borrowers are given better information to understand the full cost of the renewal before sales agents pressure them into accepting the renewal that may bring no financial benefit to the small business.

The MCA business model built upon renewals warrants the disclosure of an estimated APR for MCA products, even though their initial terms may be under one year. One provider claims that 75% of their MCA customers renew, meaning that in most cases, these short-term loans are actually repaid over longer periods of time.[4]

Transparency Problem #3: Lack of Clear Prepayment Language

We have other clients who have come to us and in certain cases we are unable to help them as we cannot extend any additional debt for a business that has taken on a high-cost loan and then had to take on more debt to make payments on the initial loan. What is often heartbreaking is that even if we were able to extend credit to refinance the business out of a high-cost loan, the borrower would often still have to pay the full amount of the fees and interest despite prepayment. They are devastated to find out that the lender charges high prepayment penalties that were not made clear to them.

These examples of small business lending transparency problems are not at all isolated to BCNA clients. My colleagues in the New York State CDFI Coalition often serve businesses that have received a predatory loan without realizing the true cost upfront. Debt-burdened businesses will come to CDFIs in a state of crisis, needing to refinance their high-cost debt before large payments cause them to fall behind on other obligations and potentially force the business to close. As mission-oriented CDFIs, we do our best to help these clients, but sometimes it is unfortunately too late. To us, the solution is clear: if these businesses received plain-language disclosures up front, they could have avoided the destruction caused by predatory loans altogether.

Progress Towards Transparency in New York State

The small business lending transparency problem persists, but BCNA and the New York State CDFI Coalition have not sat idly by. Over the course of the past 1-2 years, we worked closely with a broad coalition of CDFI and fintech lenders, advocates, and state legislators to develop a comprehensive small business financing disclosure framework in the state of New York. I am proud to share that the *New York State Small Business Truth in Lending Act* (A10118-A/S5470-B)

[3] https://www.nav.com/blog/15-the-renewal-trap-beware-of-the-mca-refinance-5476/
[4] https://slideplayer.com/slide/7525590/

passed the state legislature with bipartisan support in July.[5] Once enacted, this will serve as the nation's strongest small business lending disclosure law, building upon California's SB 1235 with even more clarity for businesses.

Federal Small Business Lending Disclosure Requirements

While I am pleased that we have successfully passed strong protections for small businesses in my home state of New York, countless business owners across the United States remain vulnerable to deceptive, high-cost lending. Chairwoman Velazquez's recently-introduced *Small Business Lending Disclosure and Broker Regulation Act* (H.R. 7889) will ensure that no small business is left behind and extend sensible disclosure protections to entrepreneurs nationwide.

H.R. 7889 importantly requires alternative lenders to disclose an estimated APR for sales-based repayment products like MCAs. These products offer businesses an advance on future receivables typically for a flat fee, and are repaid through daily or weekly automatic debits as a percentage of the business' sales revenue. Right now, sales-based financing providers often disclose the non-standard "rates" described above. Without knowing the true APR, businesses struggle to accurately weigh the costs and benefits of financing their business with an MCA or other sales-based product, a business credit card, an SBA Microloan or Community Advantage Loan, or perhaps a consumer financial product such as a home equity line of credit (HELOC).

This legislation could not have come at a better time, as businesses are now especially vulnerable to predatory lending in the midst of the pandemic. Businesses are having to navigate the process of re-opening their businesses, a process that can bring a new set of challenges and expenses as in the case of restaurants, for example, that need to set up outdoor space and are often serving fewer clients than they used to. They are also now burdened with several months of unpaid rent and other expenses. Businesses in this sector and other sectors like retail that depend on the holiday season for most of their revenue are especially vulnerable to predatory lending as they assume and hope that if they can make it through the next six months, that they will be on track to make the revenue they did before so will apply for loans with terms that seem reasonable and easy to qualify for. Businesses must receive clear information so that they fully understand the terms of these loans before accepting them, as unaffordable financing could put them over the edge under already tenuous circumstances.

It is critical that Congress acts now to advance H.R. 7889 and prevent even more devastation to entrepreneurs that have devoted their lives and livelihoods to achieving the American Dream. This country would not be what it is today without small businesses that create jobs, provide critical goods and services, and add life to the neighborhoods that are part of the cultural and economic fabric of our diverse nation. Thank you for the opportunity to testify before you today. I look forward to answering your questions.

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[5] https://www.nysenate.gov/legislation/bills/2019/a10118/amendment/a

GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Agnes N. Williams Research Professor and Professor of Law

Written Testimony of

Adam J. Levitin
Professor of Law
Georgetown University Law Center

Before the Committee on Small Businesses
United States House of Representatives

"Transparency in Small Business Lending"

September 9, 2020
1:00 pm

Witness Background Statement

Adam J. Levitin is an Agnes N. Williams Research Professor and a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in bankruptcy, commercial law, contracts, and finance regulation. He is the author of *Consumer Finance: Markets and Regulation* (Wolters Kluwer 2018), *Business Bankruptcy: Financial Restructuring and Modern Commercial Markets* (2^{nd} ed. Wolters Kluwer 2018), and, with Susan M. Wachter, *The Great American Housing Bubble* (Harvard University Press, 2020).

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, and as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP). Professor Levitin has also previously served on Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any Federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

Chairwoman Velázquez, Ranking Member Chabot, Members of the Committee:

Good afternoon. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in bankruptcy, commercial law, and consumer finance. I appear hear today as an academic who studies consumer and small business lending, without any economic interest at issue.

I applaud the Chairwoman for her bill, the Small Business Lending Disclosure and Broker Regulation Act of 2020, H.R. 7889, which would bring much needed protections to small businesses in the credit market.

The US financial regulatory system treats loans made for personal, family, or household purposes differently from loans made for business purposes. While an extensive system of regulation exists to protect consumer borrowers, there is only scant regulation of business loans.

The consumer protection system is premised on the idea that consumers often lack the information, sophistication, and market power to protect their interests. Accordingly, the consumer financial regulatory system forces the provision of information, often in standardized forms, gives consumers certain minimum rights, prohibits certain terms and transactions that are understood to be overreaching and abusive, and creates a non-judicial dispute resolution system.

The protections Congress has given consumers do not exist for businesses, which are often presumed to have greater financial sophistication and savvy. But small businesses often resemble consumers in terms of limited information, sophistication, and market power in credit markets.

Because of a lack of regulation, the nature of information small businesses receive about credit offers varies considerably. Moreover, many small businesses have owners who do not speak English as a native language, placing these businesses at a disadvantage when dealing with often technical credit documents.

Financial and legal sophistication also varies substantially among small businesses. The expertise of most small businesses is neither in finance nor law. Instead, it is in whatever their business is. Most small businesses are not regularly engaged in financing transactions. They rarely have a full time chief financial officer who specializes in financial matters, and when they borrower they are often not represented by counsel.

And small businesses lack the market power to be able to readily negotiate favorable credit terms. Small businesses are often poorly served by the financial system; many financial institutions are uninterested in small business lending in part because of the difficulties in underwriting small business borrowers. The nature of small businesses varies considerably, such that they are not susceptible to automated underwriting, which means that the costs of underwriting a small business loan relative to loan size are larger.

The reason that a borrower takes out a loan does not determine the sophistication of the borrower or the borrower's ability to otherwise protect his or her interests. Moreover, small business borrowing is often tied up with the personal credit and property of the owner because of personal guaranties.[1] Small business lenders often want the owner's credit score for underwriting, and want the owner's other property as collateral. Moreover, many small businesses have commingled used of property with their owners. A small contractor might use his truck for work, but also to get groceries and to take his kids to school. A computer in a home office might be used for both business and personal work. Accordingly, it makes sense to recognize that small businesses need many of the same sort of protections as consumer borrowers to ensure that they can enjoy fair and efficient credit markets.

My testimony proceeds by using a small business loan at a disguised 121% annual interest rate to illustrate some of the problematic issues in small business lending. I then turn to a discussion of how the Chairwoman's bill successfully addresses some of these problems. A final section suggests some clarifications or extensions of the bill.

I. Abuses in Small Business Lending: the DeRamos' Story

In 2015, Homes by DeRamo, a small, Sarasota, Florida, home construction business owned by the DeRamo family, needed cash in 2015 for operating expenses.[2] An outfit called World Business Lenders, LLC,[3] offered the business a $400,000 loan, due in 9 months, but required the DeRamos to personally guaranty the loan and pledge their home as collateral.[4] Only about $393,000 was actually disbursed after fees were deducted. Loan was formally made by Bank of Lake Mills, a tiny two-branch community bank in Wisconsin with no presence in Florida. It is unclear how the DeRamos connected with World Business Lenders in the first place.

Within weeks of making the loans to the DeRamos' business, Bank of Lake Mills assigned the loans to World Business Lenders.[5] The assignment was signed by a Vice

[1] *See* Bd. of Gov. of the Fed. Reserve Sys., SMALL BUSINESS CREDIT SURVEY: REPORT ON EMPLOYER FIRMS 5 (2017), *available at* https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-employer-finns-report.pdf (finding that 55% of small business employers personally guaranteed their business loans and 33% pledged their personal assets as collateral); Bd. of Gov. of the Fed. Reserve Sys., SMALL BUSINESS CREDIT SURVEY: REPORT ON EMPLOYER FIRMS 8 (2017), *available at* https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-nonemployer-firms-report.pdf (finding that 39% of non-employer small businesses issued personal guaranties, with 26% pledging personal assets as collateral for business debts).

[2] Complaint, *DeRamo v. World Bus. Lenders, LLC*, 2017-CA-2438-NC (Sarasota County, Fla. Circuit Court, June 16, 2017) at ¶ 7 (hereinafter "*DeRamo* Complaint"). The facts related here are drawn entirely from public filings in litigation. I have had no contact with the parties, have no interest in the case, and take no position on its ultimate merits. I am aware of the case only because as part of a scholarly project I have been tracking the trail of litigation left by the lender involved. To the extent that the facts alleged in the pleadings were controverted, they were easily confirmed either from public records, the loan documents themselves, or from the lender's own filings in other court cases.

[3] For background on World Business Lenders, *see* Zeke Faux, *Wall Street Finds New Subprime With 125% Business Loans*, BLOOMBERG, May 22, 2014.

[4] *DeRamo* Complaint at ¶ 8.

[5] *DeRamo* Complaint at pp. 152, 182. World Business Lenders, LLC subsequently assigned the loans to a securitization vehicle called WBL SPE II, LLC. *Id.* at pp. 184, 187. WBL SPE II, LLC is a wholly owned subsidiary of World Business Lenders, LLC, that World Business Lenders uses to obtain financing. Verified

President of World Business Lenders with a Power of Attorney for Bank of Lake Mills.[6] The documentation of the DeRamos' loan bears indicia that World Business Lenders was the intended assignee from the get-go: World Business Lenders' address appears in numerous places in the loan documentation,[7] and the loan documentation even provides for venue and enforcement in New York, where World Business Lenders was located at the time.[8] The DeRamo case follows a pattern of other transactions undertaken by World Business Lenders with Bank of Lake Mills and pair of other banks, Axos Federal Savings Bank (formerly Bank of the Internet (!)) and Liberty Bank.[9] In all of these cases, the loans were made by the bank and shortly thereafter transferred to World Business Lenders. In other words, Bank of Lake Mills was little more than an origination agent for World Business Lenders.

The DeRamo loan had a daily interest rate of 0.331515959726%. It also had a 15% prepayment penalty. The loan further gave the lender the right to automatically debit Home by DeRamo's bank account $3,047.42 every business day, starting four days after the date of the loan.[10] This meant that the loan amortized very rapidly, such that the DeRamos did not have use of the full disbursement for more than a few days: every week they would have over $15,000 less in working capital.

After four months of payment, the DeRamos refinanced their loan with Bank of Lake Mills, extending the maturity date, and with virtually the same daily interest rate, suggesting that the refinancing was for the purposes of extending the maturity date. They paid the 15%

Petition, *World Business Lenders, LLC v. Arena Limited SPV, LLC*, No. 653229/2019 (N.Y. Sup. Ct. N.Y. County, May 31, 2019), ¶¶ 2, 6.

[6] *DeRamo* Complaint at ¶ 24.

[7] *See, e.g., id.* at pp. 13, 31.

[8] *Id.* at p. 17.

[9] *See, e.g.*, Class Action Complaint, *Quantum-Mac Int'l, Inc. v. World Bus. Lenders, LLC*, No 1:20-cv-02353 (N.D. Ga. June 2, 2020) (Axos Bank, former BOFI Federal Bank, as rent-a-bank partner for World Business Lenders); Kaur v. World Bus. Lenders, LLC, 440 F. Supp. 3d 111, 116 (D. Mass. 2020) (BOFI Federal Bank as World Business Lenders' rent-a-bank partner); World Bus. Lenders, LLC v. 526-528 North Main St., LLC, 197 Conn. App. 269, 270-271 (2020) (120% interest rate loan made by Bank of Lake Mills and assigned to World Business Lenders); Complaint, *World Business Lenders, LLC v. Cloud & Willis, LLC*, No. 19-ev-007125 (Fulton County State Court, Ga., Dec. 27, 2019), ¶ 5 (noting that "Shortly after the Loan documents were signed, the Loan [made by Bank of Lake Mills] was sold and assigned to World Business Lenders."); Complaint, *B&S Medical Supply, Inc., N.Y. v. World Business Lenders, LLC*, No. 17-cv-03234-RMB (S.D.N.Y. 2017) (Liberty Bank, Utah, as rent-a-bank partner for World Business Lenders); Verified Complaint, WBL SPE I, LLC as Assignee of World Bus. Lenders, LLC and of Bank of Lake Mills vs. Jo Juice and Salad Bar, LLC, No. 32642/2017E (N.Y. Sup. Ct., Bronx Cnty, Oct. 26, 2017) (loan made by Bank of Lake Mills on October 20, 2016, and sold to World Business Lenders on December 2, 2014); Verified Complaint, *World Bus. Lenders, LLC v. Queens Medical Services, P.C.*, No. 600802/2016 (N.Y. Sup. Ct. Nassau Cnty, Feb. 5, 2016) (loan made by Bank of Lake Mills on March 10, 2015, sold to World Business Lenders on March 16, 2015); Verified Complaint, *World Bus. Lenders, LLC v. Michael's Landscaping Construction, LLC*, No. 611675/2016 (N.Y. Sup. Ct. Suffolk Cnty, July 26, 2016) (loan made by Bank of Lake Mills on December 9, 2015, and sold to World Business Lenders on December 14, 2015); Verified Complaint, *World Bus. Lenders, LLC v. ML Seafood Corp.*, No. 511151/2016 (N.Y Sup. Ct. Kings County, June 30, 2016) (loan made by Bank of Lake Mills on April 30, 2015, and sold to World Business Lenders on May 6, 2015)Verified Complaint, *World Bus. Lenders, LLC v. PM Recycling LLC*, No. 509595/2016 (N.Y. Sup. Ct., Kings Cnty, June 6, 2016) (loan made by Bank of Lake Mills on November 26, 2014, and sold to World Business Lenders on December 2, 2014).

[10] *DeRamo* Complaint at p.11

prepayment penalty to refinance,[11] although a simple loan amendment would not have required payment of any fee. They also took out an additional smaller loan from Bank of Lake Mills.[12] In both cases, the loans were quickly transferred to World Business Lenders.[13]

Seven months after the original loan, the DeRamos defaulted on the loans. Less than a year after that, the DeRamos brought suit against World Business Lenders alleging that the loans were usurious.[14] The DeRamos claimed that they were told that the interest rates—not the prepayment penalty—was 15%. While the interest rate was in fact disclosed in the DeRamo's actual loan agreement, it was in the form of what appeared to be a miniscule a daily rate with twelve decimal places. In fact, on an annualized basis, the interest rate was over 121%! On the "Business Loan Summary" the DeRamos received, no interest rate was quoted. While the total interest charge was listed, the only number given as a percentage was the prepayment penalty—15%. No annual percentage rate was ever given. In contrast, the APR and finance charge are required to be the most prominent term in consumer credit disclosures.[15]

Florida law caps interest charges at an 18% annual rate.[16] So how was World Business Lenders able to charge over 122% annually?[17] Because World Business Lenders had "rented" a bank.

Although state usury laws cover nonbank lenders, banks are effectively exempt.[18] High cost nonbank lenders engage in a range of transactional devices to evade state usury laws,[19]

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[11] The prepayment penalty appears to have been rolled into the refinancing. The balance at the time of refinancing was approximately $375,000, *see id.* at ¶ 12 ($640,000 principal plus finance charges minus $265,000 in payments). 15% of $375,000 is approximately $56,000. With other fees, the refinancing was for $457,000. *Id.* at ¶ 15.

[12] *Id.* at ¶ 22.

[13] *Id.* at ¶¶ 20, 24.

[14] The DeRamos allege that they were also told that their refinancing of the loan and a subsequent additional loan would be at 15%. *DeRamo* Complaint at ¶¶ 14, 22. The only 15% figure in the loan documents is for the prepayment premium. *Id.* at Exhibit 1 (p.13).

[15] 15 U.S.C. § 1632(a).

[16] 39 FLA. STAT. § 687.02.

[17] The loan documents, included as attachments the complaint, all provide for a daily interest rate of between 0.331513939726% and 0.335945205479%. *DeRamo* Complaint at pp. 13, 55, 158. On an annualized simple interest basis with a 365-day year, this is between 121% and 122.6%. The DeRamos' loans were only for 300 days, however, so in their pleadings they annualized the ratio of finance charges to principal, which resulted in rates between 72% and 74% interest. *DeRamo* Complaint at ¶ 26.

[18] Technically, federal law does not exempt banks from state usury laws so much as provide a choice of law rule that enables banks to "export" the usury cap from their home state to other states. *See* 12 U.S.C. §§ 85, 1463(g), 1831d. This means that a bank based in a state with no usury cap is not subject to other states' usury caps when it does business in those states.

[19] Examples of other devices include high cost lenders basing themselves offshore and claiming that foreign usury limits apply, *see* First Amended Complaint, *Consumer Fin. Protection Bur. v. NDG Financial Corp.*, No. 15-cv-5211 (S.D.N.Y., Dec. 11, 2015), or partnering with native American tribes or tribal members and sheltering in tribal immunity, *see, e.g.*, Complaint, *FTC v. AMG Services, Inc.*, No. 2:12-cv-00536 (D. Nev. Apr. 2, 2012); First Amended Complaint, *CFPB v. CashCall, Inc.*, No. 1:13-cv-13167 (D. Mass. Mar. 21, 2014).

but their preferred mechanism is to partner with a bank in a "rent-a-bank" arrangement.[20] That is precisely what World Business Lenders did.

In a rent-a-bank arrangement, a nonbank contracts for a bank to make loans according to the its specifications and then sell it the loans. The nonbank then claims to shelter in the bank's exemption from state usury laws and other consumer protection laws, as well as the benefit of the choice-of-law provisions applicable to the bank. And because the loan is not directly made by the nonbank, the nonbank claims that it is exempt from state licensure requirements for nonbank lenders. In exchange for renting out its regulatory privileges, the bank collects a fee.

Because of the involvement of the Bank of Lake Mills, World Business Lenders was able to respond to the DeRamo's suit that (1) the loan documentation provided that they would be governed by Wisconsin law, which has no usury rate for business loans, not Florida law, and (2) as the bank's assignee it could shelter in the bank's exemption from state usury laws.[21] What's more, because the DeRamos had defaulted on the loan, World Business Lenders sought a judgment against them (a precondition of allowing it to foreclose) in a counterclaim.[22]

The DeRamos' case ultimately settled privately, but it is illustrative of a larger phenomenon in subprime lending. Rent-a-bank arrangements are common in on-line payday lending, consumer installment lending, "marketplace lending," and subprime small business lending. Moreover, rent-a-bank lending appears likely to expand in response to the tightening of state usury laws,[23] and a set of new rulemakings by the Office of Comptroller

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[20] Financial services firms refer to these relationships solely as "bank partnership" relationships. Critics use the term "rent-a-bank" to describe the relationship. Neither is a neutral term. "Rent-a-bank" may seem inflammatory, but the anodyne "bank partnership" terminology masks the true nature of the relationship and effectively accedes to these arrangements' legitimacy as a policy matter. Moreover, the contractual documents for these relationships often explicitly disclaim the existence of a partnership. *See, e.g.*, Participation agreement, dated July 1, 2015, by and between Elastic SPV, Ltd. and Republic Bank & Trust Company https://content.edgar-online.com/ExternalLink/EDGAR/0001193125-15-371673.html?hash=949bb7318f6e6488cfa47b9c53666278efec432bfad757d790662bd149ebeb48&dest=D83122DEX991_HTM#D83122DEX991_HTM § 18 ("This Agreement is not intended to constitute, and shall not be construed to establish, a partnership or joint venture among any of the Parties."), § 19.a ("This Agreement will not create a joint venture, partnership or other formal business relationship or entity of any kind, or an obligation to form any such relationship or entity."); Participation Interest Purchase and Sale Agreement, dated August 1, 2019, by and between EF SPV, LTD, and FinWise Bank, *at* http://d18rn0p25nwr6d.cloudfront.net/CIK-0001651094/c55a048e-f8bb-41b8-ad10-bafd47e130f9.pdf ("§ 4.02 Intent of the Parties. This Agreement will not create a joint venture, partnership or other formal business relationship or entity of any kind, or an obligation to form any such relationship or entity.").

[21] Defendants, World Business Lenders, LLC's and WBL SPE II, LLC's Answer, Defenses, and Counterclaims, *DeRamo v. World Bus. Lenders, LLC*, 2017-CA-2438-NC (Sarasota County, Fla. Circuit Court, June 16, 2017) at pp. 6-7. Florida law specifically exempts banks from its usury laws. 39 FLA. STAT. § 687.12.

[22] *Id.* at pp. 9-14.

[23] On October 10, 2019, California enacted the Fair Access to Credit Act (A.B. 539), which created a rate cap of 36% on loans between $2500 and $10,000. Previously no rate cap had applied. In response, three nonbank fintech lenders, CURO, Elevate, and ENOVA, each indicated in an investor call that it were considering moving to the bank partnership model to avoid the usury cap. Elevate Credit, Inc., Q3 2019 Earnings Call, Nov. 4, 2019, https://finance.yahoo.com/news/edited-transcript-elvt-n-earnings-

of the Currency and Federal Deposit Insurance Corporation that provide legal protection to rent-a-bank arrangements against usury law challenges.[24]

I recognize that the rent-a-bank problem generally lies outside of the purview of this committee (and is not an issue limited to small businesses). Nonetheless, the regulatory vacuum created by rent-a-bank relationships—where neither state nor federal law governs the nonbank that is the true lender—makes it all the more important to strengthen and generally applicable federal regulations and expand them to small businesses.

II. The Small Business Lending Disclosure and Broker Regulation Act of 2020

The Small Business Lending Disclosure and Broker Regulation Act of 2020 is an important step toward ensuring fair treatment of small businesses in the lending market.

The core provision of the Act is to require for small business loans the disclosure of the total amount of the financing, the finance charges, the finance charges expressed as annual percentage rate (APR), payment amounts, term, prepayment cost or savings, and collateral requirements.[25] Clear disclosure of these terms is essential for borrowers to understand the nature of the obligation they are assuming. In particular, it is critical to require disclosure of finance charges in the standardized annual form of the APR. Disclosure of finance charges in a standardized form enables borrowers to more readily understand and compare various credit terms available on an apples-to-apples basis, so the borrowers can make an informed decision about using credit. Informed use of credit is essential for ensuring robust price competition, which is the first line of borrower protection.[26] The Act would also prohibit certain non-standardized used of terms.[27] And recognizing the variety of forms of small

063934139.html ("...California passed a law that caps interest rates on personal loans between $2,500 and $10,000. ...As a result, we will stop originating loans through a direct lending channel in California once the law goes into effect. However, we do not believe that it'll have a material impact on our business due to our diversified operating model and additional opportunities. One of those opportunities is to expand our underwriting and technology licensing to our 3 existing FDIC-regulated bank partners in new geographies. In addition, we are continuously looking for additional banks that share our commitment to providing innovative consumer-focused products."); Enova International (ENVA) Q3 2019 Earnings Call, Oct. 24, 2019, https://www.fool.com/earnings/call-transcripts/2019/10/26/enova-international-enva-q3-2019-earnings-call-tra.aspx ("And instead of originating near-prime loans, we plan to market and provide underwriting services for national banks originating in California."); CURO Group Holdings Corp. (CURO) Q3 2019 Earnings Call Transcript, Oct. 25, 2019, https://www.fool.com/earnings/call-transcripts/2019/10/25/curo-group-holdings-corp-curo-q3-2019-earnings-cal.aspx ("Hugh Miller -- *Buckingham – Analyst*: ...So I guess assuming that you are successful at some point in potentially creating a substitute product with the bank in California, can you just give us a sense of kind of how we should think about the start-up process for that type of initiative?... Don Gayhardt -- *President & Chief Executive Officer*: ...we do have a signed agreement....").

[24] 85 Fed. Reg. 33530, 33532 (June 2, 2020) (OCC final "valid-when-made" rule); 85 Fed. Reg. 44146 (July 22, 2020) (FDIC final "valid-when-made" rule); 85 Fed. Reg. 44223 (July 22, 2020) (OCC proposed "true lender" rule).

[25] H.R. 7889, Small Business Lending Disclosure and Broker Regulation Act of 2020, §§ 192, 193.

[26] *See* 15 U.S.C. § 1601(a).

[27] H.R. 7889, Small Business Lending Disclosure and Broker Regulation Act of 2020, § 195(b).

business financing, it would expand the definition of "finance charge" in the Truth in Lending Act to cover factoring discounts, prepayment penalties, and certain leasing charges.[28]

To see how important these disclosures are, consider the DeRamo's loan. The pricing of the DeRamo's loan was never disclosed as an annual percentage rate of 121%. Instead, it was disclosed in terms of *daily* percentage rate, which makes it look infinitesimally small: 0.331515959726%. Moreover, even the daily percentage rate was not prominently disclosed in the DeRamo's loan. It was buried in the midst of legalese. No interest rate whatsoever appeared on the summary terms sheet for the loan, and instead, the only percentage rate disclosed on that term sheet was for the prepayment penalty.

The Small Business Lending Disclosure and Broker Regulation Act of 2020 would fix this problem. It would require clear disclosure of the rate being 121% annually. Such clear disclosure would benefit both borrowers and lenders. Borrowers would know exactly what deal they were getting into, and lenders would not have to worry about borrowers claiming that they were snookered into loan terms they didn't understand. Honest lenders should embrace the proposed regulation because it creates greater clarity about loan terms that will drive the bad actors from the market.

Similarly, section 194 would require waiver of prepayment penalties when a lender refinances a loan from its existing borrower unless there is a tangible benefit to the small business from the refinancing. That provision would likely have prevented the DeRamos from being charged a 15% prepayment penalty for the privilege of refinancing their loan with the same lender for a 5-month extension at the same interest rate. To be sure, nothing would have prevent World Business Lenders from charging a fee of equal amount on the new loan, but such new fee would be a finance charge under the Truth in Lending Act and would therefore have to be disclosed as part of the APR on the new loan.

The Small Business Lending Disclosure and Broker Regulation Act of 2020 also would mandate regulation of small business loan brokers. This too is important for as we have seen repeatedly in other markets—mortgages, auto loans, and online payday and installment loans—loan brokers or auto dealers or lead generators are not incentivized to get the borrower the best deal possible, but are often incentivized to steer the borrower to the highest cost loan.[29] Moreover, brokers rarely present borrowers with all financing options in the market, but only the offers from a limited stable of lenders with whom they contract.

Borrowers are frequently unaware that the broker is not working for them, may have adverse financial interests, and may only present offers from a limited number of lenders. Requiring disclosures of loan brokers about their compensation and number of lenders they deal with as well as licensing the brokers to ensure that only reputable parties engage in loan

[28] H.R. 7889, Small Business Lending Disclosure and Broker Regulation Act of 2020, § 193.

[29] *See, e.g.*, Laurie Burlingame & Howell E. Jackson, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J. L. BUS. & FIN. 289 (2007) (mortgage broker yield spread premiums); Adam J. Levitin, *The Fast and Usurious: Putting the Brakes on Auto Lending Abuses*, 108 GEO. L.J. 1257 (2020) (indirect auto lending). Lead generators for on-line loans also sell the lead to the high bidder, which will need to recover its costs, which likely means a higher loan price.

brokering (using the SAFE Mortgage Licensing Act as a model) is an important step toward ensuring a fairer and more efficient small business lending market.

Perhaps most importantly, the Small Business Lending Disclosure and Broker Regulation Act of 2020 would give the Consumer Financial Protection Bureau the same plenary authority to regulate small business loans as it does for a "consumer financial product or service." This would enable the Consumer Financial Protection Bureau to use its power to prohibit unfair, deceptive, and abusive acts and practices to regulate small business loans, as well as to enact a "larger participant" rulemaking allowing it to supervise the major players in the small business lending market. UDAAP authority and supervisory are critical gap-filling regulatory tools that enable the CFPB to address problems that legislation cannot readily anticipate,[30] and the establishment of an Office of Broker Regulation within the Bureau would ensure a clear locus of responsibility for broker regulation.

III. IMPROVEMENTS AND EXTENSIONS

While I believe that the Small Business Lending Disclosure and Broker Regulation Act of 2020 is an important move in the right direction, I would urge consideration of a few alterations or extensions of the bill.

- In section 191, the definition of "close-end commercial credit" references UCC § 2A-103(j). I would suggest amending to merely reference the UCC. UCC § 1-203, for example, addresses whether a transaction that has the form of a lease is really a disguised security interest. It is important to incorporate that provision into the definition if the UCC is to be referenced in the first instance.
- In section 191, the definition of "Director"—should indicate that the "Bureau" is the Consumer Financial Protection Bureau.
- In section 191, I would suggest considering a narrower definition of small business financing, based not on loan size, but based on the existence of a personal guaranty or some combination of the two.
- Section 192 would amend the Truth in Lending Act to state "This title shall apply to small business financing made to a small business to the same extent as this title applies to extensions of credit made to a consumer." The term"this title," refers to the Truth in Lending Act, but problem is that the Truth in Lending Act is not a title of the United States Code. Instead, it is subchapter I of Chapter 41 (the Consumer Credit Protection Act) of title 15 of the United States Code. I do not believe that section 192 of the bill means to apply all of title 15 to small business loans. If the bill is only applying subchapter I of Chapter 41 of title 15, this should be clarified, including whether the Truth in Lending Act's mortgage provisions would apply to personal guaranties secured by real property.

[30] I note that the FTC already has power to prohibit "unfair and deceptive" acts and practices in small business lending under section 5 of the FTC Act, 15 U.S.C. § 45, but has done little with this power.

- I would urge some additional disclosures if a personal guaranty is involved, with the additional disclosures highlighting the fact that a default by the business could result in a loss of personal property by the owner.
- I would urge extending another basic consumer credit protection, the FTC's Credit Practices Rule, 16 C.F.R. Part 444, to small businesses. Doing so would, among other things, prohibit the use of confessions of judgment for small business loans.
- I would also urge a disclosure of any intended transfer of a loan by a lender at the time of origination. If a lender like Bank of Lake Mills has pre-committed to sell loans to a third party like World Business Lenders, that is important information that should be disclosed to the borrower. Borrowers should know who they are going to be dealing with on a loan, not merely the theoretical possibility that a loan can be transferred by a lender.
- I would strongly urge also applying the Electronic Fund Transfer Act to small businesses. In particular, the EFTA prohibits compulsory use of preauthorized electronic fund transfers as a condition of extending credit,[31] and gives a consumer a right to stop preauthorized electric fund transfers.[32] Without such a right, a small business that finds itself in a problematic loan has limited ability to stop paying other than by closing its bank account.

Again, while I think the Chairwoman's bill can be strengthened in places, it is an excellent starting point for bringing much needed protections to small business borrowers.

[31] 15 U.S.C. § 1693k.
[32] 15 U.S.C. § 1693e.

10XTS

Written Testimony of Michael Hiles, Founder & CEO of 10XTS, Inc.

Before the United States House of Representatives
Committee on Small Business

Hearing on "Transparency in Small Business Lending"

September 9th, 2020

Preface

Trust-enabling technologies like blockchain can now secure and automate financial records about identities, entities, assets, and transactions like lending and payments.

With a lifelong career of deploying technology solutions that help organizations work better together with automated, trusted information record networks, Michael Hiles is an advocate of using software and data to solve complex problems.

Cincinnati, Ohio, has a tremendous legacy of technology firsts. Recognized as the first independent software vendor in history, Cincom Systems[1], is where Michael's father worked in the 1970s and 80s, exposing him to early mainframe computers and software development as a child.

In 1976, the Cincinnati Stock Exchange was the first to adopt electronic trading, which has defined capital markets standards ever since.[2]

Then in 1977, Cincinnati-based Fifth Third Bank launched the first ATM funds transfer network, Jeanie. The Jeanie network was revolutionary as the first standardized electronic ATM (automated teller machine) network for moving money at the retail consumer level without requiring a physical branch location visit during operating hours for a human-powered process. That gave birth to the entire Electronic Funds Transfer (EFT) industry and ultimately how consumer banking entered the digital age at scale.

Michael's remarks today will focus on 1) how the SBA is negatively impacted by the current tidal wave of disruption in the financial services industry; 2) why the legacy financial services industry is struggling with technology; 3) how the expectations of younger consumers are changing the nature of banking and ultimately the future of how small business borrowing will work; and 4) recommendations about how the Administration and Congress can facilitate digital transformation and operational efficiency and excellence.

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[1] https://cincom.com

[2] https://www.investopedia.com/terms/c/cincinnati-stock-exchange.asp

"Transparency in Small Business Lending" – September 9th, 2020

Chairwoman Velázquez, Ranking Member Chabot, and Members of the Committee,

Thank you for the invitation to testify at this hearing. My name is Michael Hiles, and I am the CEO of 10XTS, a Cincinnati-based fintech / regtech company building blockchain solutions for financial records.

The SBA's admirable effort to rapidly mobilize financial stimulus through EIDL and PPP loans demonstrates how small business funding is clearly an essential lifeline to a thriving economy.[3] When American small business is unable to access capital, single moms, immigrants, and regular, ordinary people suffer.

The SBA has historically partnered with banks as the origination and servicing agents for lending programs. While this approach has generally allowed the SBA to serve a wider market, the Administration can only be as effective in delivering services and support as their partners.

Therein lurks the problem faced by the SBA.

The PPP program experienced significant delays in delivering financial relief to small businesses due to many bank's inability to adjust business operations in an agile fashion, and fairly deliver funds in a diverse and inclusive way. We directly experienced these frustrations.

Legacy banks are already in the throes of compressive disruption. They are not in a position to quickly respond to rapid, disruptive changes in the market. The resulting permanent branch closures and downsizing has been an alarm bell for many.[4]

In 2018, Gartner published a report indicating that by 2030, 80 percent of traditional financial services firms will close, become commoditized, or exist formally but will not compete effectively in the market.[5]

With so many consolidations, banks have struggled to merge redundant, legacy IT systems. The largest banks are a hodgepodge of "too big to fail" technologies strung together with little to no standardization.

As a result, institutions are weighed down with inefficient, fragmented processes. Our hypothesis at 10XTS is that a bevy of problems are mostly based on how information, records, documents, and data are stored, managed, shared within, and between other organizations and customers. Trusted information is still mostly another human vouching for the authenticity of documents and data.

Facing increasing regulatory scrutiny, banks have been reluctant to drive innovation due to the inherent compliance risks. The financial services industry already spends more than $270 billion per year in compliance and regulatory obligations.[6]

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[3] Office of Advocacy. (2019) *Small Businesses Generate 44 Percent Of U.S. Economic Activity*. Small Business Administration. https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/

[4] McCaffrey, O. (2020) *People Aren't Visiting Branches. Banks Are Wondering How Many They Actually Need.* Wall Street Journal https://www.wsj.com/articles/people-arent-visiting-branches-banks-are-wondering-how-many-they-actually-need-11591531200

[5] Gartner, Inc. (2018) *Digitalization Will Make Most Heritage Financial Firms Irrelevant.* https://www.gartner.com/document/code/338356

[6] Brock, Stuart. (2018) *The Cost of Compliance.* International Banker. https://internationalbanker.com/technology/the-cost-of-compliance/

Legacy systems limit simple automation and straight-through processing from the front end to the back office. Proprietary systems complicate the adoption and integration of emerging tech like blockchain, AI, robotic processing, and API-based microservices.

In short, legacy information systems reduce a bank's ability to innovate and improve value for their customers and partners.

Meanwhile, there are now approximately 60 million Generation Z banking customers who control $45 billion in annual spending. With the oldest of them nearing age 24, these young adults literally have no recollection of a life prior to the internet, social media, and mobile tech. Gen Z expects highly transactional services, placing more value upon convenience over traditional, branch-based, relationship-driven banking.[7]

In consideration of these and other things, I offer the following recommendations:

1. **Coordinate efforts with the U.S. Treasury and the Federal Reserve Bank in establishing a sandbox environment, and a decentralized, national network of financial records.**

Without a definitive path of its own, relying on the financial services industry to provide tech solutions means the SBA is at risk for future disenfranchisement of the growing market of digital-first business owners who rely upon tech solutions for fast, efficient business operation.

Similar to the early communications standards that became the internet and web, a collaborative approach to building a commercial lending and financial records network by the SBA, Treasury, tech companies, and banks could accelerate a more verdant, efficient, and trustworthy financial system.

Through collaboration, the SBA is in a position to establish new standards for financial document and information networks, data interoperability, robotic process automation, and exchange.

Firms that optimize customer data, robotic processes, and provide new solutions can offer timely and relevant support for the SBA's programs. With data-driven and digital-only models, challenger firms are in a better position to adapt to rapid change and unforeseen circumstances.

2. **Leverage and improve upon Small Business Innovation Research (SBIR) programs to foster fintech and regtech innovation.**

The SBA has an opportunity to collaborate with technology companies to provide proof-of-concepts for the direct delivery of automated services. However, Federal contracting, grant, or regulatory policies can be quite prescriptive when it comes to defining technology solution requirements.

Instead, Congress should establish goals for the outcomes of innovation programs, and then strive to support businesses that offer effective, affordable technology solutions.

While contracting vehicles already exist, they can be prohibitive for small companies to pursue due to the amount of resources required. As we've seen with recent SBIR innovations with instant procurements and

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[7] Crosman, P., Din, S., Hernandez, W. (2020) *The banking tech trends that will dominate 2020.* American Banker. https://www.americanbanker.com/list/the-banking-tech-trends-that-will-dominate-2020

streamlined processes within the Air Force, tapping into a wider, national brain trust for innovation can achieved through thoughtful improvements to the existing process.[8]

As we deliberate national small business, funding, banking, technology, and even monetary policies, Congress should invest in these opportunities, accelerate them where possible, and ensure the financial and regulatory standards and technology of the future continue to be led by American ingenuity and resolve.

Thank you again for inviting me to testify, and I look forward to addressing each of your individual questions.

[8] McCullogh, A. (2019) *Instant Contracts.* Air Force Magazine. https://www.airforcemag.com/article/instant-contracts/

CATO INSTITUTE | Center for Monetary and Financial Alternatives

September 8, 2020

The Honorable Nydia M. Velázquez
Chairwoman
Committee on Small Business
United States House of Representatives
Washington, DC 20515

The Honorable Steve Chabot
Ranking Member
Committee on Small Business
United States House of Representatives
Washington, DC 20515

Chairwoman Velázquez, Ranking Member Chabot, Members of the Committee,

Thank you for the opportunity to submit a statement for the record of today's hearing on "Transparency in Small Business Lending."

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato's Center for Monetary and Financial Alternatives, of which I am an associate director, is dedicated to revealing the shortcomings of today's centralized, bureaucratic, and discretionary monetary and financial regulatory systems and to identifying, studying, and promoting alternatives more conducive to a stable, flourishing, and free society.

Recent Trends in U.S. Small Business Lending

U.S. small businesses account for 43.5 percent of U.S. gross domestic product and 47.3 percent of private-sector employment.[1] Yet they face unique challenges in their access to credit which the economic uncertainty stemming from the Covid-19 pandemic has underlined. Most small-business borrowers need relatively small loans that are individually expensive to underwrite, originate, and service unless done on a large scale.[2] But many small businesses also have special

[1] Kathryn Kobe and Richard Schwinn, "Small Business GDP 1998-2014," Small Business Administration Office of Advocacy, December 2018, p. 4; SBA, "2019 Small Business Profile," Office of Advocacy, 2019.
[2] Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Innovation and Technology and the Implications for Regulation," Harvard Business School Working Paper 17-042, 2016, p. 24-25.

circumstances and funding needs that do not fit the standard credit box, which explains why they have historically benefited greatly from relationship lending.[3]

Lenders of many different types cater to small businesses, from banks and credit unions to state-licensed finance companies offering both short- and longer-term loans. In recent years, a new category of lenders that use technology to simplify the borrowing process has emerged. Some of these new entrants have focused on making loan applications easier and more transparent, while others use their access to detailed business cash-flow information to improve underwriting. Still others prioritize quick access to funds, which is crucial to many small businesses that expect revenue tomorrow but need to pay bills today. As of 2019, 33 percent of U.S. small businesses seeking credit applied to online lenders.[4]

But not all recent trends are encouraging. Since the 2008 financial crisis, bank loans to businesses for amounts less than $1 million have grown at rates substantially below those of the pre-crisis period, and much more slowly than loans above that threshold. In the eight years to 2018, loans under $1 million grew only by 3 percent, compared with 80 percent for loans above that amount.[5] The extent to which nonbank lenders have helped to plug this shortfall is hard to estimate, but for years after the last recession small businesses reported tight credit conditions.[6] No sooner had the climate improved in late 2018 and 2019 than Covid-19 put the U.S. economy in recession, credit markets in disarray, and millions of small businesses in existential crisis.

But the public health emergency will pass. And policymakers can take steps that, in addition to easing small businesses' recovery, can permanently improve their access to capital. Here, I focus on three areas: the cost of credit, the use of data in underwriting, and the collection of small-business loan data for fair lending purposes. None of the policy approaches suggested need come at the expense of transparency; in fact, some of them would probably make credit terms and lender decision-making easier for small businesses to understand.

Cost of Credit: Caps, APR Disclosures, and Alternative Approaches

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[3] Mitchell A. Petersen and Raghuram G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *Journal of Finance* Vol. 49 No. 1 (March 1994): pp. 3-37; Allen N. Berger and Gregory F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *Journal of Business* Vol. 68 No. 3 (July 1995): pp. 351-381.

[4] Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, St. Louis, and San Francisco, "Small Business Credit Survey: 2020 Report on Employer Firms," p. 15.

[5] Michael D. Bordo and John V. Duca, "The Impact of the Dodd-Frank Act on Small Business," NBER Working Paper 24501 (April 2018), National Bureau of Economic Research, p. 3.

[6] National Federation of Independent Businesses, "Expected Credit Conditions," accessed September 9, 2020. http://www.nfib-sbet.org/indicators/

According to the Federal Reserve Banks' Small Business Credit Survey, cost was the top reason small businesses cited for declining at least some of the credit for which they had been approved.[7] But the top three reasons for credit denial *by lenders*, according to the same sample of firms, were carrying too much debt, a low credit score, and insufficient collateral.[8] Firms in this situation can often only secure additional credit by offering to pay a higher interest rate. Because there is such a tradeoff between cost and other terms, blunt interventions like a statutory cap on loan interest are bound to backfire. And because women- and minority-owned firms tend to be smaller than other small businesses[9] and their owners tend to have lower credit scores,[10] they would bear a disproportionate share of a cap's impact on credit availability.

In an attempt to increase transparency, policymakers and some lenders have recently championed legislation mandating certain disclosures for small business credit, akin to those applicable to consumer credit.[11] Often, these initiatives have focused on a single cost measure, namely the annual percentage rate (APR), which proponents hope will make credit applicants better able to compare alternatives. But a single measure can deceive: The APR, for example, makes no distinction between products with different repayment schedules, even though avoiding upfront fees can clearly benefit liquidity-constrained small businesses. The APR also tends to favor loans with a longer term, even if they carry higher total charges than shorter-term alternatives.

The APR is a useful comparator for similar products, but it can mislead a borrower facing many options with different characteristics. A product's total dollar cost can often be a more accurate measure of affordability, especially for short-term credit. But making any single cost measure mandatory is risky, as it discourages lenders from competing on other product features that small businesses value, such as repayment flexibility and speed of access, because they become less visible. Instead of interest-rate caps and ineffective disclosure mandates, policymakers should seek to promote additional entry into small-business lending. They should also encourage innovation by lenders through programs such as the CFPB's trial disclosure sandbox.[12]

New Forms of Underwriting

While credit scores remain very important for credit decisions, many lenders have recently started to use additional data to underwrite applicants. Early evidence shows these additional

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[7] Federal Reserve Banks, "Small Business Credit Survey," p. 13.
[8] Ibid.
[9] Consumer Financial Protection Bureau, "Key Dimensions of the Small Business Credit Landscape," May 2017, p. 8 and 10.
[10] According to survey data, 88 percent of employer small businesses rely on the owner's personal credit score when they apply for credit. Federal Reserve Banks, "Small Business Credit Survey," p. 8.
[11] See, for example, S.B. 1235 in California, which became law in September 2018 and requires small business lenders to disclose credit terms, including cost as an annualized rate.
[12] 84 FR 48260, "Policy to Encourage Trial Disclosure Programs," September 13, 2019.

data can increase credit availability and reduce its cost for both consumers and small businesses.[13] But existing regulatory guidance, such as the Federal Reserve Board's 2011 letter on model risk management,[14] may discourage lenders from trying out innovative underwriting methods or doing business with firms that do, lest these methods be regarded as potentially discriminatory or unsound. And while the Supreme Court's 2015 *Inclusive Communities* ruling defined clear boundaries for disparate-impact claims, its application to future ECOA enforcement actions remains uncertain.

Even before the Covid-19 pandemic hit, many small businesses struggled to secure all the financing they sought. Although it is important for policymakers not to encourage the proliferation of credit that borrowers later cannot repay, they should also watch out against well-meaning supervisory and enforcement practices that drive out potentially beneficial innovation. As the Court noted in 2015, "liability must be limited so . . . regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant free-market economy."[15] If an innovation stands to make all or most borrowers better off, it should be welcome even if the benefits are unevenly distributed at the outset.

Loan Data Collection

Researchers benefit greatly from the public availability of loan data. For example, the finding cited earlier of a sluggish recovery in bank commercial lending to small businesses comes from FDIC Call Report data. But data collection also has costs, which can discourage lenders from participating in certain markets and serving certain customer segments. Even if a data collection requirement has net benefits, it can harm individual borrowers or groups by causing the withdrawal of marginal lenders for which the compliance cost is too high.

Congress and regulators should seek to minimize this unintended consequence in the small-business loan data collection mandated by Section 1071 of the Dodd-Frank Act.[16] While Section 1071 seeks to ensure fairness in lending to women- and minority-owned small businesses, its implementation could drive out thousands of small banks and credit unions with a relatively small commercial lending footprint. By exempting banks, thrifts, and credit unions with assets below $1 billion from Section 1071 requirements, Congress or the CFPB would relieve more

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[13] Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform," Working Paper 18-15 (January 2019), Federal Reserve Bank of Philadelphia; FinRegLab, "The Use of Cash-Flow Data in Underwriting Credit," Small Business Spotlight, September 2019.

[14] Patrick M. Parkinson, "SR 11-7: Guidance on Model Risk Management," Board of Governors of the Federal Reserve System Division of Banking, April 4, 2011.

[15] *Texas Department of Housing and Community Affairs, et al. v. Inclusive Communities Project, Inc., et al.* 576 U.S. 10 (2015).

[16] 15 U.S. Code § 1691c-2.

than 85 percent of these institutions from a heavy compliance burden, while still allowing for data collection on nearly 90 percent of their small-business loans.[17]

Conclusion: Promoting Transparency and Credit Availability

It is costlier for lenders to serve the smallest of small businesses and those in unusual circumstances. As a result, these businesses, owned disproportionately by women and minorities, often struggle the most to secure credit. But competition between a wide range of lenders and ongoing innovation and specialization have helped to bring costs down. While policy interventions can help to improve the transparency of loan terms and credit decisions, policymakers should be careful not to constrain the availability of credit in the process. Broad access to credit on competitive terms can make all the difference to small businesses fighting to survive the Covid-19-induced recession.

Thank you again for the opportunity to submit a statement for the record. I would be happy to answer any questions you may have at DZuluaga@cato.org.

Sincerely,

Diego Zuluaga
Associate Director, Financial Regulation Studies
Center for Monetary and Financial Alternatives
Cato Institute

[17] Diego Zuluaga, "Implementation Concerns of Section 1071 of the Dodd-Frank Act," Submission to the CFPB Symposium on Small-Business Lending, Cato Institute, November 6, 2019.

WRITTEN STATEMENT

U.S. HOUSE COMMITTEE ON SMALL BUSINESS

HEARING ON

TRANSPARENCY IN SMALL BUSINESS LENDING

SEPTEMBER 9, 2020

JOHNATHON BUSH, NOT JUST COOKIES

CHICAGO, ILLINOIS

Dear Chairwoman Velázquez, Ranking Member Chabot and Members of the Committee:

Thank you for allowing me to share comments with you about the detrimental impact predatory lending has on small businesses, especially in light of challenges stemming from the COVID-19 pandemic.

I recently filed for Chapter 7 bankruptcy. With business down due to COVID-19 and my cash reserves depleted, I was left with no other option. While the pandemic may have been the nail in the coffin, it was not what set my business up to fail. Two years, ago I made a financial decision that's had long-lasting impacts on my business and put me in a precarious position well before the pandemic first made headlines—all because it's legal for small business lenders to disclose important costs and loan terms.

At the age of 13, I began by selling cookies to family and friends. By the age of 20, I opened a storefront in Chicago, was operating a kiosk in the heart of the city, and was managing multiple contracts with grocery stores and cafeterias. It was a dream come true; but it quickly came crashing down.

Like any ambitious entrepreneur, I was determined to keep growth going and I sought financing to reinvest in my business. I needed capital to make operational upgrades and attract new clients.

Cash-strapped, I took two loans totaling $40,000 from a merchant cash advance company. I thought I had full information about the financing I was taking and that the company was trusted. What I didn't know, however, was what was happening behind the scenes.

After the Great Recession, traditional small business lending substantially dropped. Because many banks view small businesses as riskier borrowers, in recent years lenders have increased credit and collateral requirements on small business loans. These requirements favor larger businesses, making it nearly impossible for true Main Street businesses to secure a traditional loan. This has disproportionately impacted women and minority-owned businesses, and respectively they receive just over 4% and 5% of conventional loans.

Seeking to capitalize on this void and to turn a quick buck, alternative lenders sprouted up by the dozens. These lenders offer the promise of fast cash, baiting borrowers into agreeing to a loan before disclosing the true price and terms. Some predatory lenders disguise interest rates as high as 400% APR in murky, and often confusing, financial jargon.

As you know, unlike payday loans for consumers, online and other alternative small business financing companies operate in an almost entirely unregulated market where it is legal for bad actors to disguise their fees or fail to provide that information altogether.

There is a common misconception that business owners are experts in all areas of running a business. However, that is not always the case. Unlike large corporations, small businesses often do not have the resources to hire accounting firms or seek financial advice from consultants.

When I took out my loans, I was a young entrepreneur on a quest to make my business as successful as possible, only armed with the information at hand.

The company had not disclosed how aggressive the repayment schedule would be, and before I knew it, I was completely broke. In normal times the impact of a predatory loan is hard enough to manage, but add in the pandemic, and I was left with no choice but to file for bankruptcy.

With millions of small businesses in need of a lifeline, predatory lending has the potential to crush America's small business community, and it has highlighted the underlying issues that have plagued small businesses, particularly businesses owned by people of color, for years.

As we speak, loan sharks are circling struggling small businesses waiting to pounce and take them for all they have. The current gap in federal funding could very well be the opening that they need.

It is expected that more than one in four small businesses will not survive the next three months without more help, making it all the more likely that business owners will be left with no choice but to turn to alternative lenders to stay afloat.

This is why I urge you to act now to rein in alternative lenders, as outlined in the Small Business Lending Disclosure and Broker Regulation Act, to ensure more entrepreneurs don't lose their businesses during this critical time.

Thank you for the opportunity to share my story with you.

Jonathan Bush, owner
Not Just Cookies
Chicago, Illinois

RESPONSIBLE BUSINESS LENDING COALITION

Testimony for the Record

Submitted to the
House Committee on Small Business

For the Hearing
"Transparency in Small Business Lending"
September 9, 2020

Submitted by the Responsible Business Lending Coalition

Chairwoman Velázquez and Ranking Member Chabot, the Responsible Business Lending Coalition (RBLC) thanks you for convening an important hearing on transparency in small business lending. The RBLC is the only cross-sector coalition of nonprofit and for-profit lenders, investors, and small business advocates that share a commitment to innovation in small business lending and serious concerns about the rise of irresponsible small business lending. We are grateful to the Chairwoman for inviting RBLC member Luz Urrutia, CEO of Accion Opportunity Fund, to serve as a witness in this hearing.

Today's discussion on lending transparency could not have been timelier given the heightened importance of transparent small business financing disclosures amid the pandemic. Due to the business interruptions caused by COVID-19, small businesses need responsible financing now more than ever to bridge revenue losses and adapt their business models. Businesses seeking capital to weather the uncertain months ahead are currently presented with non-standardized or misleading disclosures from some financing companies, making it challenging to compare different financing options, choose affordable products, and avoid debt traps.

The lack of price transparency in small business financing today is undermining market competition, stymying innovation, and misleading small business into paying unnecessarily high rates. For small businesses already on the brink of closure amid the pandemic, choosing an unaffordable credit product unknowingly could be the difference between survival and failure.

Small Businesses Lack Access to Transparent Capital

The lack of transparency in small business financing is a problem that has created unnecessary burdens for entrepreneurs seeking capital since long before the COVID-19 crisis. Commercial financing has never been subjected to Truth in Lending Act, which requires transparent disclosure of pricing and terms for consumer credit products. This lack of transparency exposes small businesses to undue financial risk. In this regulatory gap, the small business credit marketplace has evolved and grown significantly in recent years, expanding access to capital for entrepreneurs while simultaneously increasing the complexity of products offered to business borrowers. The RBLC believes that innovation must be met with responsible lending standards to ensure that small businesses are treated fairly and can make informed decisions.

To this end, in 2015 the RBLC authored the Small Business Borrowers' Bill of Rights detailing the fundamental financing rights that all small businesses deserve, and the practices that lenders must abide by to uphold those rights.[1] The Borrowers' Bill of Rights includes the Right to Transparent Pricing and Terms, which calls for small business financing providers to clearly disclose seven key elements to businesses applying for credit:

1. Loan amount, and total amount provided after deducting fees or charges
2. Annual percentage rate (APR) or estimated APR
3. Payment amount and frequency, including the actual or estimated total payment amount per month if payment frequency is other than monthly
4. Term or estimated term
5. All upfront and scheduled charges
6. Collateral requirements
7. Any prepayment charges

The Need for Universal APR Disclosure

Disclosure of these key terms, particularly the APR or estimated APR, is critical to help small businesses compare different financing products and make informed decisions. APR is the only metric that enables apples-to-apples comparisons of products with different fees, interest, and term lengths over a common unit of time. Paying $10,000 to rent an apartment for a month is not the same as paying $10,000 to rent for a year. The same is true in financing, which is the rent of money over a period of time. Without APR, a prospective borrower could not quickly compare the cost of borrowing $10,000, for example, using a five-year term loan with a 15% interest rate and $1,000 origination fee, to a 12-month cash advance with a 4% fee rate, to a credit card with a 24.9% interest rate.

Some financing companies that charge high APRs have argued that the dollar total of fees and interest charged is sufficient for small businesses to understand pricing. However, a business cannot easily compare the cost of products with different repayment durations (e.g. a 12-month cash advance compared to a five-year loan) using total cost of capital alone. Too often, small business financing providers not only fail to provide an APR but also disclose different so-called "rates," such as a "fee rate" or "simple interest rate" that are lower than the actual interest rate or APR and lead small businesses to underestimate the cost of certain products.

The Federal Reserve Board and Federal Reserve Bank of Cleveland conducted an in-depth study of small businesses' experiences with alternative, online lenders offering a variety of

[1] Responsible Business Lending Coalition, "Small Business Borrowers' Bill of Rights," 2015. http://www.borrowersbillofrights.org/uploads/1/0/0/4/100447618/bbor_for_web_-2020.pdf

products including lines of credit, merchant cash advances (MCA), and loans.[2] In the study, researchers presented small business owners with disclosures for different financing products currently available to small businesses. Researchers found that "non-standard terminology" used by some alternative lenders "proved challenging for focus group participants trying to compare online offerings with traditional credit products."[3] They provided the small businesses with a sample product – "a $50,000 MCA with a factor rate of 1.2 and total repayment of $60,000" – and asked participants to guess the equivalent interest rate. Participants all received exactly the same information but "responded with a wide range of estimates."[4] The true APR was roughly 40%.

The Federal Reserve's research clearly demonstrates that many business owners do not understand the disclosures currently provided by some financing companies. The table below, from the Federal Reserve's research, shows how easy is it to misunderstand the "non-standard" information presented by some financing companies.

Table from the Federal Reserve's "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites" (p. 18)

[2] Federal Reserve Board, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

[3] Ibid.

[4] Federal Reserve Board, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf

Table 3. Estimated APRs for select online products

Rate advertised on website	Product details	Estimated APR equivalent
1.15 factor rate	• Total repayment amount $59,000 • Fees: 2.5% set-up fee; $50/month administrative fee • Term: none (assume repaid in six months) • Daily payments (assume steady payments five days/week)	Approximately 70% APR
4% fee rate	• Total repayment amount $56,500 • Fee rate: 4% (months 1–2), 1.25% (months 3–6) • Fees: none • Monthly payments • Term: six-month term	Approximately 45% APR
9% simple interest	• Total repayment amount $54,500 • Fees: 3% origination fee • Weekly payments • Term: six-month term	Approximately 46% APR

Source: Authors' calculations, based on product descriptions on company websites.

Without a clear understanding of the terms presented to them, small businesses risk taking out higher-cost debt that may prove to be unaffordable, under the false assumption that it will be less expensive than other available options. The Federal Reserve research demonstrated that a small business is likely to assume that it will be less costly to cover an unexpected expense with a merchant cash advance charging a 1.15% factor rate, as shown in the example above, than to use a credit card with a 30% APR. However, as the table shows, the credit card's 30% APR is far lower than the MCA's 70% APR. It is important to note that small businesses are often deciding between funding their business with commercial financing products or a consumer product that is quoted in terms of APR. In addition to credit cards, businesses often use personal loans, auto loans, and home equity lines of credit alongside commercial financing like merchant cash advances.

As the right-hand column above illuminates, APR disclosure for all types of financing would give small businesses a common language with which to compare the cost of differently-structured products. In order to achieve full transparency and ensure that businesses can easily compare offers, APR must be disclosed for various types of financing, as well as for products with terms less than one year. While some claim that disclosure of an annualized rate is generally inappropriate for terms under one year, in the context of small business financing, short-term products are frequently renewed or refinanced to expand the initial repayment amount and duration. One provider states: "Approximately 90% of our Merchant Cash Advance clients participate in the program more than once. In fact, the average customer renews about ten times!"[5] Therefore, a product that begins with an expected term under one year will likely extend beyond this period after renewals are accounted for, so APR disclosure upfront would be reasonable and useful to small businesses considering shorter-term financing.

The financing companies using misleading rates could transparently inform small businesses of the APR, but may fear that if small businesses were informed of the high APRs they would be charged, some of those businesses would instead seek more affordable financing. In essence, instead of the market exhibiting healthy price competition and driving prices down, some financing companies are earning economic rent on their customers' lack of information.

Impact of Undisclosed High APRs on Small Business Borrowers

As Ms. Urrutia noted in her testimony, RBLC founding member Opportunity Fund conducted an analysis on the impact of high-cost loans on small businesses.[6] They analyzed the business cash flow and loan terms of 104 small businesses that had taken out alternative loans, finding that businesses had been charged average APRs of 94%, and as high as 358%, without those APRs having been disclosed to the borrowers. The high APRs also proved to be unaffordable. Analysts found that average monthly loan payments were nearly double the small business' net income available for debt payments. Opportunity Fund noted that "this unsustainable ratio severely hampers an owner's ability to expand a business or hire new employees, and drastically undermines the long-term viability of an enterprise."

RBLC members too often hear from small business owners who have taken out costly debt from alternative lenders, with terms that were not presented clearly upfront, seeking to refinance the debt into a lower-cost product with affordable payments. Responsible lenders do all they can to bring relief to these businesses and prevent high payments from putting the business at risk. Sometimes lenders are able to refinance the debt, and sometimes it is too late. In an attempt to keep up with unaffordable payment obligations, some businesses take out additional high-cost debt and use new loan proceeds to repay the original loan. With some financing providers encouraging small businesses to take on new loans that the business cannot truly afford, businesses can quickly get caught in debt traps that have the potential to drain all of the business' resources and force them to shut down.

Addressing the Small Business Lending Transparency Problem

Small businesses have borne the brunt of irresponsible and non-transparent lending practices for too long. Main Street cannot afford the status quo to continue, particularly now given the additional financial burdens that COVID-19 continues to impose on small businesses. It is critical that policymakers take bipartisan action to bring commonsense rules of the road to small business lending. To start, lawmakers should require understandable and consistent disclosures

[5] Rapid Advance, "RapidAdvance Merchant Cash Advance Program," 2016: http://web.archive.org/web/20161110041235/http://www.rapidadvance.com:80/merchant-cash-advance

[6] Opportunity Fund, "Unaffordable and Unsustainable: The New Business Lending on Main Street," 2016. https://www.opportunityfund.org/wp-content/uploads/2019/09/Unaffordable-and-Unsustainable-The-New-Business-Lending-on-Main-Street_Opportunity-Fund-Research-Report_May-2016.pdf

from financing companies to help small businesses to make informed decisions while enabling market innovation and access to a broad range of financing tools. Information asymmetry, where one party to the transaction has more information than the other, prevents free market competition that can foster market growth and drive down the cost of capital. Small businesses need access to clear information about the price and terms of financing products upfront so that they can make financial decisions that help, rather than harm, their businesses.

The RBLC applauds Chairwoman Velázquez for leading the way to small business lending transparency. On July 30, 2020, the Chairwoman introduced the *Small Business Lending Disclosure and Broker Regulation Act of 2020* (H.R. 7889). Building upon state bills passed and soon to be implemented in California and New York, H.R. 7889 would require all providers of small business financing (in amounts under $2.5 million) to disclose APR or estimated APR and other key terms to borrowers at the time a small business is approved for financing. This legislation would bring transparency to all small businesses nationwide just as small businesses face unprecedented economic uncertainty and record levels of business closures due to the pandemic. The disclosure framework detailed in H.R. 7889 has been supported by a variety of responsible private-sector fintech lenders and nonprofit CDFI lenders, as well as advocacy and civil rights groups. However, portions of the high-cost lending industry, including merchant cash advance and factoring providers, may continue to oppose the requirement to disclose APR or estimated APR as the basis for apples-to-apples comparisons of differently structured products.

High-Cost Lenders May Oppose APR Transparency

Higher-cost lenders express their support for transparency in principle but oppose disclosure of the most critical metric, APR, that small businesses told the Federal Reserve would be helpful for understanding and comparing different financing products.[7] In direct opposition to the Fed's research findings on small business lending disclosures, high-cost cash advance and similar providers claim that APR disclosure would confuse, rather than inform borrowers. However, the Federal Reserve found that borrowers are currently confused by the "non-standard terminology" that APR opponents use to describe and market their products.[8] The Fed notes that for small business borrowers like those included in their study, "determining the equivalent APR on some products may be challenging" because non-standard metrics used by alternative, high-cost providers are not well understood.

Opponents also claim that estimated APR for sales-based products would be difficult to calculate and unhelpful to borrowers. For cash advance or other products that are repaid as a percentage of daily or weekly sales, there is no set repayment term (e.g. 12 months). Borrowers pay their lender a set percentage of their revenue (e.g. 20% of receipts) until the loan and fees are repaid in full. Sales-based providers must estimate the time it will take businesses to repay in order to determine the expected term duration and estimate an APR. Fortunately, these providers already collect their small business borrowers' historical sales volumes during the application process and

[7] Federal Reserve Board, "Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites," 2019. https://www.federalreserve.gov/publications/files/what-small-business-borrowers-find-when-browsing-online-lender-websites.pdf
[8] Ibid.

could use this information to calculate expected time to repayment. Sales-based financing companies already project annualized rates for their investors. They can easily disclose these (often high) rates to their customers but may prefer not to.

Providing an APR estimate, quoted to borrowers as such, would give small businesses a clearer understanding of loan pricing than the "non-standard" metrics currently disclosed. Without estimated APR, product descriptions that the Fed has found to cause significant confusion would continue to include unclear metrics that are not comparable to other loan offers the business may be considering. Small businesses need universal APR or estimated APR disclosure for all products in order to make informed decisions.

Conclusion

The RBLC looks forward to continued dialogue with Committee Members on the need for greater transparency in small business financing and for APR disclosure in particular. We urge bipartisan support for H.R. 7889 that would create a level playing field for small businesses and lenders alike by requiring clear and consistent disclosures of pricing and terms, including APR for all products. This commonsense solution would not place burdensome restrictions on the types of financing that providers may offer or impose price ceilings. Rather, H.R. 7889 would simply provide small businesses with the information they need to understand complex financial products and choose financing that enables their business to grow and thrive. Thank you again, Chairwoman Velázquez and Ranking Member Chabot for bringing this important issue before the Committee today.

Signed,

The Responsible Business Lending Coalition

Members include:

Accion Opportunity Fund
Community Investment Management
Funding Circle
LendingClub
Opportunity Finance Network
Opportunity Fund
Small Business Majority
StreetShares
The Aspen Institute